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IN THE

Supreme Court of the United States

October Term, 1983

CHEMICAL BANK,
Petitioner,

—against—

ARTHUR ANDERSEN & CO.,
Respondent.

MANUFACTURERS HANOVER TRUST COMPANY AND FIRST PENNSYLVANIA BANK, N.A.,
Petitioners,

—against—

ARTHUR ANDERSEN & CO.,
Respondent.

SECURITY PACIFIC NATIONAL BANK,
Petitioner,

—against—

ARTHUR ANDERSEN & CO.,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETER GRUENBERGER
Counsel of Record

IRWIN H. WARREN
PHILIP A. BYLER
RICHARD L. LEVINE
WEIL, GOTSHAL & MANGES
767 Fifth Avenue
New York, New York 10153
(212) 310-8000
Counsel for Petitioners
Manufacturers Hanover Trust Company
First Pennsylvania Bank, N.A.
Security Pacific National Bank

HAROLD R. TYLER, JR.
MICHAEL B. MUKASEY
ANN LOEB
PATTERSON, BELKNAP, WEBB, AND TYLER
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000
Counsel for Petitioner
Chemical Bank

August 17, 1984

Questions Presented

1. Whether the majority of the Second Circuit panel, in finding an absence of federal subject matter jurisdiction in this securities law case because it concluded that there had been no fraud "in connection with" the purchase or sale of a security (a pledge of stock), failed to follow the controlling test of *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), by dismissing *Superintendent*'s "touching" test as mere "literary style" and by reverting to the very test expressly discredited in *Superintendent* itself—*i.e.*, that a well pleaded securities fraud claim has no jurisdictional basis unless the fraud directly concerns the "value" of the securities in question?

2. Whether the Second Circuit majority, in inferring against petitioners that the pledge of stock was "merely an incident" to a major capital financing transaction, failed to follow controlling precedent of this Court on the standards for the issuance of summary judgment, when it made such inference in the face of the pleadings and uncontroverted sworn statements that petitioner banks would not have advanced millions of dollars to a now-bankrupt company and its wholly-owned subsidiary but for (a) the parent company's guarantee of payment and the pledge of the stock of such subsidiary and (b) the written and oral misrepresentations of the respondent certified public accounting firm?

3. Whether this Court should apply its reasoning in *Securities Industry Association* v. *Board of Governors*, 52 U.S.L.W. 4943 (U.S. June 28, 1984), to reverse the Second Circuit and hold that the definition of a "security" for the purposes of the antifraud sections of the federal securities laws includes unsecured notes with a maturity exceeding 11 months issued to banks in a major capital financing and restructuring?

Parties to the Proceeding

Petitioners (plaintiffs) are four banks: Chemical Bank, Manufacturers Hanover Trust Company, First Pennsylvania Bank, N.A., and Security Pacific National Bank. Respondent (defendant) is Arthur Andersen & Co. There are three other named defendants in this action: Gerald Lee, Mervyn Silver, and Joseph Heilbrun, all former officers of the now-bankrupt Frigitemp Corporation. (Also, 21 John Doe defendants are mentioned in the complaint of Chemical Bank, none of whom was ever served with process.)[1]

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1. The statements required by Rule 28.1 of this Court are contained in Appendix A to this Petition at 1a. The Appendix to this Petition is bound together with the Petition. References to the Appendix are cited herein as "(a)."

TABLE OF CONTENTS

	PAGE
Questions Presented	I
Parties to the Proceeding	II
Table of Authorities	VI
Opinions Below	2
Jurisdiction	2
Statutes and Regulation Involved	3
Statement of the Case	3
Reasons for Granting the Writ	7
I. This Case Poses An Important Question Concerning The Scope Of The Federal Securities Laws' Antifraud Provisions That Should Be Settled By This Court	8
II. The Second Circuit's Restriction Of The "In Connection With" Test Is In Direct Conflict With *Superintendent Of Insurance* v. *Bankers Life & Casualty Co.*	11
III. The Second Circuit's Decision Creates A Serious Conflict Among The Circuits Regarding The "Touching" Test	20
IV. The Second Circuit's Decision Directly Conflicts With This Court's Rulings Concerning The Standards For Summary Judgment	23
V. The Second Circuit's Decision That The Replacement Notes Are Not "Securities" Is In Conflict With This Court's Reasoning In *Securities Industry Association* v. *Board Of Governors*	25
Conclusion	28

PAGE

APPENDIX:

A. Statements Pursuant to Rule 28.1 ..... 1a

B. Opinion of the United States Court of Appeals for the Second Circuit, dated January 20, 1984 (726 F.2d 930) 5a

C. Opinion of the United States District Court for the Southern District of New York, dated December 21, 1982 (552 F. Supp. 439) 44a

D. Order of the United States Court of Appeals for the Second Circuit Denying Rehearing, dated March 21, 1984 ..... 82a

E. Order of the Hon. Thurgood Marshall Granting Petitioners' Application for an Extension of Time, dated June 6, 1984 ..... 84a

F. Section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) 85a

G. Section 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(3) 86a

H. Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) 86a

I. Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) 87a

J. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) 88a

K. Rule 10b-5, 17 C.F.R. § 240.10b-5 ..... 89a

PAGE

L. Opinion of the United States Supreme Court in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) 90a

M. Opinion of the United States Court of Appeals for the Second Circuit in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 430 F.2d 355 (2d Cir. 1970) 98a

N. Opinion of the United States District Court for the Southern District of New York in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 300 F. Supp. 1083 (S.D.N.Y. 1969) 112a

TABLE OF AUTHORITIES

PAGE

Cases:

Adickes v. S.H. Kress & Co., 398 U.S. 144 (1970) 23
Aeronca, Inc. v. Gorin, No. 80 Civ. 1509 (S.D.N.Y. filed Mar. 14, 1980) 5 n.4
Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) 8 n.7, 9
Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F.2d 615 (9th Cir. 1981) 21 n.16
A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967) 18, 22 n.17

Banco Nacional De Costa Rica v. Bremar Holdings Corp., 492 F. Supp. 364 (S.D.N.Y. 1980) 27 n.23
Brown v. Ivie, 661 F.2d 62 (5th Cir. 1981), *cert. denied*, 455 U.S. 990 (1982) 22

Chemical Bank v. Arthur Andersen & Co., 552 F. Supp. 439 (S.D.N.Y. 1982), *rev'd*, 726 F.2d 930 (2d Cir. 1984) ..... *passim*
Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811 (2d Cir. 1975) 18–19, 22 n.17

Equitable Life Assurance Society v. Arthur Andersen & Co., No. 79 Civ. 4882 (S.D.N.Y. filed Sept. 14, 1979) 5 n.4
Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 8 n.7
Exchange National Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976) 25–26, 25 n.21, 27

Golden v. Garafalo, 678 F.2d 1139 (2d Cir. 1982) ..25, 28 n.24

Herman & MacLean v. Huddleston, 459 U.S. 375 (1983) 8 n.7, 9, 18

In re Frigitemp Corporation, No. 78 B. 468 (Bankr. S.D.N.Y. filed Mar. 20, 1978) 4 n.2

PAGE

Leasco Data Processing Equipment Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972) 23–24
Litowitz v. Arthur Andersen & Co., No. 78 Civ. 3100 (S.D.N.Y. filed July 10, 1978) 5 n.4

Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979) 22
Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980) 15 n.11, 19 n.14
McClure v. First National Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) 26
McGrath v. Zenith Radio Corp., 651 F.2d 458 (7th Cir.), *cert. denied*, 454 U.S. 835 (1981) 21–22

Peerless Insurance Co. v. Arthur Andersen & Co., No. 80 Civ. 2556 (S.D.N.Y. filed May 6, 1980) 5 n.4

Rubin v. United States, 449 U.S. 424 (1981) 5, 8 n.7, 9 n.8, 27 n.22

Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975) 16 n.11
Seagrave Corp. v. Vista Resources, Inc., 696 F.2d 227 (2d Cir. 1982), *cert. granted*, 52 U.S.L.W. 3827 (U.S. May 15, 1984) (No. 83-1084) 8 n.7, 28 n.24
SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) 9, 17 n.13
SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) 25 n.20
SEC v. Garfinkle, [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,465 (S.D.N.Y. June 9, 1978) 27 n.23
SEC v. W.J. Howey Co., 328 U.S. 293 (1946) 25 n.20
Securities Industry Association v. Board of Governors, 52 U.S.L.W. 4943 (U.S. June 28, 1984) 1, 26–27
Steele v. Bulova Watch Co., 344 U.S. 280 (1952) 23

PAGE

Superintendent of Insurance v. Bankers Life and Casualty Co., 300 F. Supp. 1083 (S.D.N.Y. 1969), *aff'd*, 430 F.2d 355 (2d Cir. 1970), *rev'd*, 404 U.S. 6 (1971) ..... *passim*

Tcherepnin v. Knight, 389 U.S. 332 (1967) 25 n.20
TSC Industries v. Northway, 426 U.S. 438 (1976) 8 n.7

United States v. Arthur Young & Co., 104 S. Ct. 1495 (1984) 10
United States v. Diebold, Inc., 369 U.S. 654 (1962) 23
United States v. George G. Davis, 82 Cr. 00564-02 (S.D.N.Y. filed Aug. 17, 1982) 5 n.3
United States v. George G. Davis, 83 Cr. 00551-03 (S.D.N.Y. filed Sept. 16, 1983) 5 n.3
United States v. Gerald E. Lee, 82 Cr. 00564-01 (S.D.N.Y. filed Aug. 17, 1982) 5 n.3
United States v. Gerald E. Lee, 83 Cr. 00551-04 (S.D.N.Y. filed Sept. 16, 1983) 5 n.3
United States v. Kendrick, 692 F.2d 1262 (9th Cir. 1982), *cert. denied*, 103 S. Ct. 1892 (1983) 20–21
United States v. Naftalin, 441 U.S. 768 (1979) 8 n.7, 10 n.8, 17
United States v. Newman, 664 F.2d 12 (2d Cir. 1981) 20

Weaver v. Marine Bank, 637 F.2d 157 (3d Cir. 1980), *rev'd*, 455 U.S. 551 (1982) 22 n.17, 27–28, 28 n.24

Statutes:

Section 2(1) of the Securities Act of 1933, 15 U.S.C.A. § 77b(1) (Supp. 1984) 3
Section 3(a)(3) of the Securities Act of 1933, 15 U.S.C.A. § 77c(a)(3) (1981) 3
Section 17(a) of the Securities Act of 1933, 15 U.S.C.A. § 77q(a) (1981) ..... 3, *passim*

PAGE

Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78c(a)(10) (Supp. 1984) 3
Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78j(b) (1981) ..... 3, *passim*
28 U.S.C.A § 1254(1) (1966) 2
28 U.S.C.A. § 1292(b) (1966) 6 n.5

Regulations and Rules:

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1983) ..... 3, *passim*
Fed. R. Civ. P. 12(b)(1) and (6) 24 n.19
Fed. R. Civ. P. 12(c) 24 n.19

Other Authorities:

2 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud*, § 4.7(574)(3) at 88.34 (1979) 20
5 A. Jacobs, *Litigation & Practice Under Rule 10b-5*, § 38.01(b) (2d ed. 1981) 11–12 n.9

Nos. 83-

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner banks (hereinafter the "Banks") respectfully request that a writ of certiorari issue to review the decision

and judgment of the United States Court of Appeals for the Second Circuit entered on January 20, 1984. A divided panel of that Court reversed a denial by the United States District Court for the Southern District of New York of respondent's motions for summary judgment and dismissal, holding that subject matter jurisdiction was lacking because (a) the Banks had not alleged a fraud "in connection with" the purchase or sale of securities (pledged stock), and (b) notes evidencing almost $20 million of advances in a major capital financing were deemed not to be "securities" for purposes of the federal securities laws.

Opinions Below

The opinions of the divided panel of the Second Circuit are reported at 726 F.2d 930 (2d Cir. 1984), and are reproduced in Appendix B (5a-43a). The opinion of the District Court is reported at 552 F. Supp. 439 (S.D.N.Y. 1982), and is reproduced in Appendix C (44a-81a). Citations to such opinions are to the relevant page in the Appendix.

Jurisdiction

After entry of judgment by the Second Circuit, the Banks filed a timely petition for rehearing with a suggestion for re-hearing in banc. On March 21, 1984, that petition was denied by an order which is reproduced in Appendix D (82a). On June 6, 1984, the Honorable Thurgood Marshall, Associate Justice of this Court, granted petitioners' application for an extension of time in which to file this petition to and including August 18, 1984, by an order reproduced in Appendix E (84a). The jurisdiction of this Court is invoked under 28 U.S.C.A. § 1254(1) (1966).

Statutes and Regulation Involved

The pertinent federal statutes and regulation here that prohibit securities fraud are provisions proscribing fraud "in" and "in connection with" the purchase or sale of a security: § 17(a) of the Securities Act of 1933 ("the 1933 Act"), 15 U.S.C.A. § 77q(a)(1981); § 10(b) of the Securities Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C.A. § 78j (b)(1981); and Rule 10b-5 promulgated by the Securities Exchange Commission under § 10(b), 17 C.F.R. § 240.10b-5 (1983). The relevant provisions defining "security" are § 2(1) of the 1933 Act, 15 U.S.C.A. § 77b(1) (Supp. 1984); § 3(a)(3) of the 1933 Act, 15 U.S.C.A. § 77c(a)(3)(1981); and § 3(a)(10) of the 1934 Act, 15 U.S.C.A. § 78c(a)(10) (Supp. 1984). The relevant portions of these statutes and regulation are reprinted in Appendices F through K (85a-89a).

Statement of the Case

The Banks filed these actions in 1979 under the anti-fraud provisions of the above federal securities laws and state common law against respondent Arthur Andersen & Co. ("Andersen"), the certified public accountant and auditor from 1973 to 1978 for the now-bankrupt Frigitemp Corporation ("Frigitemp").

In the early 1970's, Frigitemp was a small corporation that embarked on a program of rapid expansion and major corporate acquisitions, requiring large amounts of capital. Because it was unable to raise sufficient funds in the public debt and equity markets, it was forced to turn primarily to the Banks for such funds. Prior to Frigitemp's bankruptcy in 1978, the Banks poured nearly $20 million into Frigitemp and today are still owed over $12 million plus interest (48a).

The Banks sued Andersen, basing federal subject matter jurisdiction on the capital financing and restructuring of Frigitemp, including the large infusion of new capital completed in August 1977 ("the August 1977 transaction"). The Banks alleged that Andersen made knowingly false and misleading representations concerning Frigitemp in certified financial statements and in direct oral communications with the Banks. The Banks provided the financing to Frigitemp, involving fully two-thirds of Frigitemp's total debt, in specific reliance upon Andersen's 1976 fiscal year-end audit, written certifications and oral representations that Frigitemp was an increasingly profitable and financially healthy company.

There were several interrelated parts to the August 1977 transaction. Based upon the undisputed record before it, the district court held that "it really should be viewed as one integrated transaction" (72a n.30), in which the Banks (a) made a new investment decision in August 1977 by extending the maturity dates on $15.5 million of Notes —both secured (the "Note Endorsements") and unsecured (the "Replacement Notes")—which they had previously received from Frigitemp, based upon prior certifications by Andersen; and (b) advanced $4 million of new money to Frigitemp's wholly-owned subsidiary, Elsters, Inc., and received Frigitemp's pledge of 100% of Elsters Common Stock, which secured Frigitemp's guarantee of Elsters' repayment (47a-48a).

In March 1978, less than one year after the August 1977 transaction, Frigitemp filed a petition in bankruptcy,[2] and Elsters subsequently was liquidated. Shortly thereafter, Andersen withdrew all its prior certifications, upon which the Banks had relied, of Frigitemp's financial statements (for fiscal years 1973 through 1976), acknowledging that

2. *In re Frigitemp Corporation*, No. 78 B. 468 (Bankr. S.D.N.Y. filed March 20, 1978).

they may have been materially misstated and were not to be relied upon. It then resigned as auditor, but too late for the Banks, which by then had lost $12 million plus interest.

These events spawned massive federal litigation: certain Frigitemp officers were prosecuted and convicted for federal crimes involving fraud and racketeering;[3] the two principal Andersen accountants on the Frigitemp account invoked the Fifth Amendment privilege; and a number of federal civil actions have been filed and pursued.[4]

In the instant case, more than two years after the action was commenced and extensive discovery taken (49a), Andersen moved for dismissal and for summary judgment. The district court denied Andersen's motions in all respects, holding that the complaints of the Banks stated a claim under the antifraud provisions of the securities laws and upholding jurisdiction on two separate grounds. First, under this Court's decision in *Rubin* v. *United States*, 449 U.S. 424, 431 (1981), Frigitemp's pledge of Elsters stock was a sale of securities, and under this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co., supra*, 404 U.S. 6 ("*Superintendent*") (Appendix L attached hereto at 90a-97a), the fraud occurred "in connection with" that pledge of Elsters stock. Second, the unsecured Replacement Notes issued in the integrated

3. *United States* v. *Gerald E. Lee*, No. 82 Cr. 00564-01 (S.D.N.Y. filed Aug. 17, 1982); *United States v. George G. Davis*, No. 82 Cr. 00564-02 (S.D.N.Y. filed Aug. 17, 1982); *United States v. Gerald E. Lee*, No. 83 Cr. 00551-04 (S.D.N.Y. filed Sept. 16, 1983); *United States* v. *George G. Davis*, No. 83 Cr. 00551-03 (S.D.N.Y. filed Sept. 16, 1983).

4. *Litowitz* v. *Arthur Andersen*, No. 78 Civ. 3100 (S.D.N.Y. filed July 10, 1978) (shareholder class 10b-5 action which was settled by respondent); *Equitable Life Assurance Society* v. *Arthur Andersen*, No. 79 Civ. 4882 (S.D.N.Y. filed Sept. 14, 1979) (noteholder 10b-5 action); *Aeronca, Inc.* v. *Gorin*, No. 80 Civ. 1509 (S.D.N.Y. filed Mar. 14, 1980) (settled by respondent); *Peerless Insurance Co.* v. *Arthur Andersen*, No. 80 Civ. 2556 (S.D.N.Y. filed May 6, 1980).

August 1977 transaction constituted a sale of "securities", thereby implicating the federal securities laws.[5]

On appeal, the Second Circuit, in a split decision, reversed. First, the panel unanimously held that the Replacement Notes were not "securities" under the antifraud provisions of the federal securities law; rather they were treated as simple "commercial loans" to finance "current operations" (23a-24a), although Frigitemp had turned to the Banks for such financing due to its inability to float a common stock issue (8a & n.2), and although the Banks had provided the financing in the August 1977 transaction based on their belief that without it Frigitemp would have gone bankrupt (32a). Second, the majority held that, while the pledge of the Elsters stock indeed was a sale of a security by Frigitemp, the alleged fraud was not "in connection with" that pledge, because Andersen did not misrepresent the value of Elsters or its stock (33a). Disregarding the broad "touching" test which this Court established in *Superintendent,* and demoting that test to a matter of "literary style" (31a), the majority concluded that the pledge was "merely an incident" in a transaction not otherwise involving the purchase or sale of securities (34a n.24). The majority so concluded even though it expressly assumed that the August 1977 financing for Frigitemp, which included the pledge of Elsters' stock to secure Frigitemp's guarantee, constituted "one single, integrated refinancing package" (10a) and that the Banks had sufficiently alleged that Andersen had committed fraud regarding Frigitemp and its finances (33a n.22).[6] This holding was based on the very reasoning and language which this Court expressly had discredited in *Superintendent.*

5. The district court (81a) certified an interlocutory appeal of the jurisdictional questions only pursuant to 28 U.S.C.A. § 1292(b) (1966).

6. Denial of Andersen's motion below insofar as it was addressed to the merits was based on the District Court's findings that the Banks had demonstrated the existence of genuine issues of material fact (50a n.9) and that *scienter* sufficiently had been alleged (76a-77a).

The dissent below, relying on the uncontroverted documents and affidavit submitted by the Banks, pointed out that "[t]his was a single transaction, a package deal, no part of which could have stood alone" (38a), and further noted it was undisputed that the Banks "would not have advanced $4 million unless Frigitemp guaranteed" repayment (*id.*). It reasoned that the consideration to the Banks for that part of the transaction was "Elsters' promise of repayment plus a pledged asset and a guarantee of Elsters' allegedly solvent parent company" (*id.*). The dissent concluded that it would be "simply to blink reality" to assert, as the majority had, that "the Banks got exactly what they expected" when they received no benefit at all from the pledge of the Elsters stock (*id.*). The ability of Frigitemp to make good on its guarantee and the extent to which the Elsters stock would have to be looked to as security made the Andersen certifications crucial (41a). In this context, the dissent demonstrated that the test set forth by the majority for interpreting the "in connection with" test was contrary to precedent, in particular this Court's decision in *Superintendent,* in which the alleged fraud did *not* relate to the value of the securities at issue (40a).

Reasons for Granting the Writ

By dismissing the "touching" test with respect to accountants' fraudulent certifications which induced the Banks to accept the pledge of stock as security for capital financing, the majority decision below too narrowly construed the scope of the federal securities laws and created a direct conflict with *Superintendent.* Its resulting new rule of law is: federal jurisdiction does not exist when an accounting firm induces a transaction which includes the pledge of a security by misrepresenting the financial condition of the parent-guarantor-pledgor, so long as in the same transaction the firm makes no direct misrepresentation as to the value of

the wholly-owned subsidiary's pledged securities. In so holding, the decision signals a retreat from, and is in direct conflict with, not only *Superintendent* and subsequent broad readings by this Court of the scope of the antifraud provisions, but also the decisions of four other Circuits, this Court's recent pronouncement on the expansive duties of certified public accountants, and the appropriate standard for granting summary judgment. Moreover, the decision's restrictive re-definition of the term "securities" to exclude the notes here from the coverage of the federal securities laws represents a significant step backwards in light of this Court's broad definition of "security" in a recent case interpreting the Glass-Steagall Act.

I. This Case Poses An Important Question Concerning The Scope Of The Federal Securities Laws' Antifraud Provisions That Should Be Settled By This Court

In restricting the "in connection with" test so as to make irrelevant the fraud as to the financial condition of Frigitemp (the parent-guarantor-pledgor), this case poses an important question of federal jurisdiction: what is the "connection" between an alleged fraud and a securities transaction necessary to invoke the coverage of the antifraud provisions of the federal securities laws?[7]

7. Related questions as to such scope repeatedly have been accorded great importance by this Court since *Superintendent*. *See, e.g., Herman & MacLean* v. *Huddelston*, 459 U.S. 375 (1983) (an implied right of action under § 10(b) of the Securities and Exchange Act of 1934); *United States* v. *Naftalin*, 441 U.S. 768 (1979) (antifraud provisions of the Securities Act of 1933 prohibit frauds against brokers, not just investors); *Rubin* v. *United States*, 449 U.S. 424 (1981) (pledge of stock to bank as collateral for loan is sale of a security); *TSC Industries* v. *Northway*, 426 U.S. 438 (1976) (materiality); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (scienter); *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972) (reliance). Recently, in *Vista Resources, Inc.* v. *Seagrave Corp.*, 52 U.S.L.W. 3827 (U.S. May 15, 1984) No. 83-1084, this Court granted a petition for a writ of certiorari to determine whether the sale of a 100% stock interest in a business is a securities transaction within the meaning of the federal securities laws.

1. This Court answered that question more than a decade ago in *Superintendent* when it created the "touching" test for application of the "in connection with" language of § 10(b) of the 1934 Act and Rule 10b-5. This interpretation was premised on this Court's longstanding principle that § 10(b) and Rule 10b-5 "must be read flexibly, not technically and restrictively", *Superintendent* (95a), a rationale often articulated by this Court: *Herman & MacLean* v. *Huddleston,* 459 U.S. 375, 386-87 (1983); *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151 (1972); *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180, 195 (1963). But in the instant case, the Second Circuit majority implied (31a-34a) that this Court really did not mean what it held in *Superintendent* by adopting the very language and rationale of the lower court rulings in *Superintendent* which this Court had expressly rejected and reversed, and consequently has created a direct conflict with the precedents of this Court and with other circuits. (*See* Points II and III, *infra*).[8] If *Superintendent*

8. There now appears to exist an undesirable element of uncertainty concerning the application of *Superintendent* in cases involving § 17(a) of the 1933 Act and pledges of securities. This Court in *Rubin* v. *United States,* 449 U.S. 424, 429 n.6 (1981), held that a pledge of stock to a bank as collateral for a loan was a securities transaction; in a footnote, a question said to be left open regarding the 1933 Act was "whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a)." That question under the 1934 Act had already been answered in the affirmative by *Superintendent.* The *Rubin* Court, we submit, could not have meant to imply either that (a) the requisite relationship between an alleged fraud and a securities transaction for invoking the coverage of the antifraud provisions of the federal securities laws is different for pledges than for other kinds of sales of securities; or (b) the "in connection with" language of § 10(b) of the 1934 Act and Rule 10b-5 has a different meaning from the "in" language of § 17(a) of the 1933 Act. Neither distinction is theoretically sustainable. Since pledges of stock are securities transactions within the meaning of both Acts, it would make little sense to give different meanings to the "in" and the "in connection with" language in each Act depending upon the type of security under scrutiny. And as this Court has already recognized, and as

(footnote continued on next page)

can be dismissed merely as "literally style" (31a), then the adverse implications of the Second Circuit's majority decision will be felt not only in private suits, but also in criminal and SEC proceedings which repeatedly have been premised on *Superintendent*'s "touching" test.

2. This case also presents an occasion to examine an additional issue of public importance: the responsibilities of public auditors and the standards of their liability under federal law. Recently, this Court in *United States* v. *Arthur Young & Co.*, 104 S. Ct. 1495 (1984), recognized the important responsibilities of the independent certified public accountant:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.

104 S. Ct. at 1503 (emphasis in the original). The Banks, which were the major financiers of Frigitemp, seek civil redress under the federal securities laws against this independent auditor because it failed to live up to the obligations discussed in *Arthur Young*. If the Second Circuit's majority decision is not reversed, the federal policy of *Arthur Young* will be frustrated, because after years of litigation in federal court, the Banks will be relegated to starting over again in state court—even though this accounting fraud has resulted in a spate of *federal* civil 10b-5

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accepted by the Second Circuit in this case (30a), the "in connection with" phrase of § 10(b) of the 1934 Act and the "in" language of § 17 of the 1933 Act have been used interchangeably. *United States* v. *Naftalin*, 441 U.S. 768, 773 n.4 (1979). By granting the writ here, this Court can clarify this important area of law.

suits against Andersen and Frigitemp officers, *federal* criminal prosecutions of Frigitemp officers, and *federal* bankruptcy proceedings for that corporation.

II. The Second Circuit's Restriction Of The "In Connection With" Test Is In Direct Conflict With *Superintendent Of Insurance* v. *Bankers Life & Casualty Co.*

The conclusion that the fraud in this case was not "in connection with" Frigitemp's pledge of the Elsters stock in the August 1977 transaction because the pledge was "merely an incident in a transaction not otherwise involving the purchase or sale of securities" (34a n.24), is in direct conflict with this Court's decision in *Superintendent*, which rejected the identical rationale and language more than a decade ago, and which instead adopted the flexible "touching" test.

In *Superintendent*, the defendants engaged in a fraudulent scheme to take control of Manhattan Casualty Company ("Manhattan") by using Manhattan's own money to pay for it: Manhattan was induced to sell approximately $5 million worth of United States Treasury bonds, the proceeds of which were misappropriated by defendants and used to purchase all of Manhattan's stock. The district court and the Second Circuit both ruled that such fraud was not "in connection with" the sale of the Treasury bonds. This Court reversed, holding that even though "the full market price was paid for [the] bonds . . ." (92a), and thus no fraud related to the value of the securities, the requisite § 10(b) fraud had been pleaded, because "Manhattan suffered an injury as a result of deceptive practices *touching* its sale of securities. . . ." (95a) (emphasis supplied).[9]

9. The common understanding of the "touching" language of *Superintendent* as intending a broad and flexible test is illustrated in

(footnote continued on next page)

Here the Second Circuit majority chose not to follow *Superintendent;* rather, it purported to overrule a decision of this Court regarding the "in connection with" test. After dismissing the "touching" test as merely "literary style" and noting with skepticism that *Superintendent* had "pushed the perimeters rather far" (32a), the Second Circuit majority substituted its own test:

> The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be. Andersen is not alleged to have deceived the Banks with respect to the pledge of the Elsters stock; the Banks got exactly what they expected. Their showing is simply that but for Andersen's description of Frigitemp they would not have renewed the Frigitemp loans or made the Elsters loan which Frigitemp guaranteed, and that if they had not done this, there would have been no pledge of Elsters' stock.

(33a-34a).[10]

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5 A. Jacobs, *Litigation & Practice Under Rule 10b-5,* § 38.01(b), at 2-43 to 2-44 (2d ed. 1981):

> The "in connection with" clause would ordinarily be fulfilled if a securities transaction is involved in some way, even though the fraud did not occur in the purchase or sale that is attacked (assuming the fraud and securities transaction can be integrated into the same scheme), the deceit did not concern the terms of the securities transaction, the claimant was not a party to the deceptive transaction, the fraud and the loss were merely indirectly connected, the securities transaction was only tangentially related to the fraudulent course of conduct, and the fraud was not aimed at causing a purchase or sale of a security.

10. Nothing in the record supports the majority's erroneous conclusion that the Banks "got exactly what they expected." The Banks certainly did not expect: to lose over $12 million plus interest on the transaction; Frigitemp to go into bankruptcy; or Elsters to be liquidated, rendering the pledged stock completely worthless.

The majority in every critical respect thus echoed the precise language, holding and reasoning that had been employed in *Superintendent* by the Second Circuit, 430 F.2d 355 (2d Cir. 1970) (Appendix M attached hereto at 98a-111a), and by the district court, 300 F. Supp. 1083 (S.D. N.Y. 1969) (Appendix N attached hereto at 112a-152a), but which were expressly *rejected* by this Court's reversal in *Superintendent*.

1. The district court and Second Circuit in *Superintendent* and the Second Circuit's majority opinion here (as quoted above) each ruled that, unless the alleged fraud related directly to the value of the securities in issue, the federal antifraud provisions are not implicated. The district court in *Superintendent* had also held that the "in connection with" requirement was not satisfied because the seller allegedly got what he bargained for:

> *Each security transaction herein was effected for full and fair consideration* with full knowledge in both purchaser and seller as to the value of the securities sold.

(151a) (emphasis supplied). Similarly, on appeal in *Superintendent*, the Second Circuit stated:

> *With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded.* . . . Indeed, it is not part of the liquidator's claim that the full and fair market price was not paid for those bonds by their purchaser. The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. *There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received.*

(107a) (emphasis supplied). This is one of the points on which this Court reversed in *Superintendent*. Although the

full price had been paid for Manhattan's Treasury bonds (92a) and thus fraud did not exist as to their "value", this Court determined that the fraud had "touched" the transaction, thus subjecting the entire transaction to the anti-fraud provisions of the 1934 Act. By regressing to its own more restrictive view that the fraud must relate to the value of the security (here, the pledged stock)—the same test rejected by this Court in *Superintendent*—the Second Circuit here disregarded this Court's broad "touching" test.

2. Both lower courts in *Superintendent* and the Second Circuit majority below incorrectly sought to carve a distinction between fraud in connection with a securities transaction on the one hand, and a securities transaction that is part of fraudulent activity on the other. The district court in *Superintendent* had made the same distinction, ruling that in order for federal jurisdiction to exist, the securities part of a transaction had to be "at the crux" of the scheme or be the "object of" the fraud—*i.e.*, fraud as to collateral matters is not sufficient (145a):

> A federal claim is not pleaded by allegations that, in the course of a scheme to loot a corporation of its assets, certain security transactions occurred, when these transactions—though contaminated by the overriding evil intent to accomplish the ultimate looting—did not involve fraud or deceit in connection with the sale or purchase of a security.
>
> Manifestly, the sale of Manhattan's portfolio and the purchase of the Manhattan shares were necessary steps toward the ultimate looting of Manhattan's assets. *But Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.*

(146a-47a) (emphasis added). After the Second Circuit's affirmance, this Court in *Superintendent* rejected any such distinction by establishing the "touching" test: a claim is

stated as to any fraud when a person suffers "injury as a result of deceptive practices touching" a purchase or sale of securities (95a).

Ignoring the indisputable facts that the loan to Elsters, the guarantee and the pledge were one transaction, and that the misrepresented financial condition of the parent was the *sine qua non* for dealing with the subsidiary, the Second Circuit majority here rejected the broad touching test, and reverted to the discredited approach and language of the district court in *Superintendent*:

> We do not question that the complaint stated a claim of common law fraud with regard to the Elsters loan since the misrepresentations relating to Frigitemp affected its guarantee. But this is irrelevant to the issue whether Andersen is liable under § 10b of the 1934 Act or § 17a of the 1933 Act when it made no misrepresentation as to the only "security" involved in the transaction, to wit, the Elsters stock. (33a n.22).
>
> * * *
>
> *The Act and Rule impose liability for a proscribed act in connection with the purchase or sale of a security; it is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the pledge of a security is a part.*
>
> (34a) (emphasis supplied).[11]

11. To support this position, the Second Circuit majority employed an illogical theory of "loss causation" (34a n.23) completely incompatible with *Superintendent*. The majority held that while the Banks had adequately alleged "transaction causation" (*i.e.*, that they would not have made the loan and accepted the pledge of stock *but for* the fraud), the Banks had not alleged "loss causation." However, there would have been a lack of "loss causation" in *Superintendent* under the Second Circuit's erroneous test, since that alleged fraud did not relate to the value of the Treasury bonds. As the Second Circuit itself previously recognized in *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980), in minimizing the utility of "loss causation" analysis:

(footnote continued on next page)

3. Both the district court in *Superintendent* and the Second Circuit majority in this case incorrectly viewed the securities transaction at issue as "merely an incident" to the fraudulent activity. In *Superintendent*, as here, plaintiff contended that "there was but one pervasive fraudulent scheme, and that all of the various security transactions and their financial maneuvres were interrelated and cumulative." (144a). The district court there denied jurisdiction, ruling that:

> the consummation of a security transaction was a *mere incident* of a fraudulent scheme and the mere fact of injury caused by the fraud, in the absence of any possibility that the fraud might materially affect the purity of the security transaction and the purity of the trading process[,] would not make the fraud federally cognizable.

(146a) (emphasis supplied). While this Court in *Superintendent* dismissed that line of reasoning in favor of the "touching" test, the Second Circuit majority repeated its earlier error and used the same rejected language here:

> Differentiating transaction causation from loss causation can be a helpful analytical procedure only so long as it does not become a new rule effectively limiting recovery for fraudulently induced securities transactions to instances of fraudulent representations about the *value characteristics of the securities dealt in.* So concise a theory of liability for fraud would be too accommodative of many common types of fraud, such as *the misrepresentation of a collateral fact that induces a transaction.*

629 F.2d at 710 n.3 (emphasis supplied). This Court should not allow the glib phrase "loss causation" to swallow the rule of *Superintendent,* particularly where, as here, both "transaction causation" (the Banks would not have entered into any part of the August 1977 transaction but for the fraud) and "loss causation" (the Banks lost many millions of dollars, including $4 million of newly advanced money in the August 1977 transaction) exist. *See also Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied,* 421 U.S. 976 (1975) ("[loss causation] is demonstrated rather easily by proof of some form of economic damage.").

> the pledge of the Elsters stock, as to which no fraud is alleged, was *merely* an *incident* in a transaction not otherwise involving the purchase or sale of securities.

(34a n.24) (emphasis supplied).[12]

4. Both the district court in *Superintendent* and the Second Circuit majority here premised their rejected "in connection with" test on their overly restrictive view of the purpose of the 1934 Act. *Compare*, "[t]he securities acts are not so much concerned with fraud *per se* as with the effect of fraud upon investors . . ." (145a), *with* "[t]he purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions. . . ." (33a). But this Court in *United States* v. *Naftalin*, 441 U.S. 768 (1979), made clear that such a restrictive outlook ran counter to a broader purpose of the antifraud provisions:

> [N]either this Court nor Congress has ever suggested that investor protection was the *sole* purpose of the Securities Act. . . .

441 U.S. at 775 (emphasis in the original).[13] While the dissenting judge below expressly recognized it (39a), the

12. The Second Circuit majority attempted to support its new test with a hypothetical: the pledge of General Motors stock by a commercial borrower (35a). As correctly recognized by the dissent, the hypothetical bore no relationship to the facts and realities of the present case (41a-42a). The GM hypothetical involved an ordinary commercial loan and a pledge of the publicly-traded stock of one of our nation's largest and strongest companies, which has an immediately ascertainable, realizable and liquid value, to secure the debt of an unrelated borrower, whose bankruptcy would have no effect on the pledge of the GM stock. The integrity of that security would remain intact. In contrast, the instant case involved a major capital financing and restructuring (induced by Andersen) of Frigitemp, a small, struggling company requiring major financing. The banks demanded Frigitemp's pledge of 100% of the stock of its wholly-owned subsidiary Elsters, a small, nonpublic company whose stock had no readily ascertainable market value, to secure the parent's guarantee of payment of that subsidiary's debt. The bankruptcy of Frigitemp and the liquidation of Elsters led to the Banks' loss of $12 million. Here, the integrity of the security of the pledged Elsters stock totally was destroyed.

13. *See also SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 186-87 (1963).

majority ignored the consistent admonition of this Court in *Superintendent* (95a), and restated in other cases, most recently in *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-87 (1983), that courts must "read section 10(b) flexibly, not technically and restrictively."

5. The majority decision below conflicts directly with an important body of precedent in the Second Circuit holding that a fraud need not relate to the value of the securities at issue in order to sustain federal securities law jurisdiction. For instance, this Court in *Superintendent* expressly relied (94a n.7) on *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967), for its broad and flexible construction of the phrase "in connection with". There, a broker brought a federal securities fraud action against its customers for placing orders for securities with the intent of paying only if the securities had appreciated by the time payment was due. Despite the fact that the alleged fraud did not relate to the value of securities, the Second Circuit in *A.T. Brod* ruled that the antifraud provisions of the federal securities laws applied, stating:

> [A] 10b-5 action will survive even though the fraudulent scheme or device is unrelated to "investment value."

375 F.2d at 397.

In *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811 (2d Cir. 1975), the plaintiff mutual fund alleged that in order to induce it to retain one Yamada to manage a portion of plaintiff's portfolio, the defendant accounting firm had misrepresented the financial position of Takara Partners—a private investment fund controlled by Yamada. Plaintiff had retained Yamada in reliance (as here) on defendant's false certification of Takara's financial statements, and had lost several million dollars as a result of purchases and sales of securities which Yamada, in his capacity as advisor, had caused it to make

—just as Andersen's similar acts misled the Banks into entering the August 1977 transaction and as a result caused them even a greater loss. The district court in *Competitive Associates* dismissed the complaint because no allegation had been made that the accountants had misstated the financial condition of any of the companies whose securities were traded by Yamada, thus no "connection" was found to exist between the fraudulent misrepresentations as to Takara and the losses to plaintiff resulting from such purchases or sales of the securities by Yamada (the test and reasoning applied by the Second Circuit majority here). The Second Circuit reversed, however, because the fraudulent scheme *touched upon* Yamada's transactions in securities, even though the fraud related directly neither to those securities nor their value, nor even to the transactions in which they were purchased and sold. The grounds of that reversal aptly apply here:

> The finding of the district court that the auditing and certification activities of defendant[] [accountant] was not conduct[ed] "in connection with the purchase or sale" of a security involving plaintiffs within the meaning of section 10(b) and Rule 10b-5 is error. . . . *The broad "touch" test enunciated in* [*Superintendent*] *is certainly met by plaintiff's allegations that the very purpose of defendant*['*s*] *certification of Takara's financial statement was to aid in placing Yamada in a position where he could manipulate securities prices and sell these securities to investors* attracted by Yamada's reputation and performance.

516 F.2d at 815 (emphasis supplied).[14]

14. *Accord Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d. Cir.), *cert. denied*, 449 U.S. 1011 (1980) (claim by customer against person who misrepresented that he was a registered stockbroker upheld, even though the statements about the securities on which the customer lost money were not fraudulent, "since the misrepresentation [as to his status] was such as to induce both their purchases and their holding of the securities" (*id.* at 708); defendant was liable where "the misrepresentation of a *collateral* fact . . . induces a transaction" (*id.* at 710 n.3) (emphasis supplied)).

United States v. *Newman*, 664 F.2d 12 (2d Cir. 1981), involved the criminal prosecution of a securities trader who received and passed on confidential information about prospective takeovers from employees of investment banking companies. The Second Circuit reversed a dismissal of the indictment, holding that under this Court's reading in *Superintendent* of the "in connection with" language of Rule 10b-5, stealing valuable nonpublic information had a sufficient connection with the purchase or sale of securities (even absent fraud relating to the value of any security):

> [T]he [*Superintendent*] Court construed the phrase "in connection with" flexibly to include deceptive practices "touching" the sale of securities, *id.* 404 U.S. at 12, 92 S. Ct. at 168, a relationship which has been described as "very tenuous indeed". 2 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodity Fraud*, § 4.7(574)(3) at 88.34 (1979).

664 F.2d at 18.[15]

III. The Second Circuit's Decision Creates A Serious Conflict Among The Circuits Regarding The "Touching" Test

The Second Circuit's decision creates a serious conflict with decisions in four other circuits which expressly have applied *Superintendent*'s broad "touching" test in aid of federal antifraud enforcement. In none of these Circuits must the fraud relate to the value of the securities in issue; in each, fraud as to collateral facts was held to be enough.

1. *Ninth Circuit:* In *United States* v. *Kendrick*, 692 F.2d 1262 (9th Cir. 1982), *cert. denied*, 103 S. Ct. 1892 (1983), Kendrick, a broker, established margin accounts at

15. Conviction following remand was affirmed by unreported order No. 82-1273 (2d Cir. February 8, 1983), *cert. denied*, 104 S. Ct. 193 (1983).

Dean Witter & Co. for two of his customers secured by securities pledged by those customers. Kendrick subsequently drew unauthorized drafts on those accounts, misrepresenting to Dean Witter that they were loans for his customers and to his customers that they were withdrawals for the purpose of buying securities for their account. Dean Witter recorded the transactions as loans secured by the previously pledged stock, and (as here) made the loans in reliance on Kendrick's fraudulent misrepresentations. Based on *Superintendent's* flexible "touching" test, the Ninth Circuit upheld Kendrick's criminal conviction on the ground that his fraud had occurred "in connection with" the pledge of securities, despite a "touching" there much more tenuous than in the instant case, because in *Kendrick:* (a) no misrepresentation occurred as to the value of the pledged securities, (b) the pledge had *preceded* and was *not* induced by any fraudulent statements, and (c) a new pledge of securities had *not* been made in connection with the loans in issue. Conversely, here the pledge was *contemporaneous* with and was induced by the fraud, and *new* loans were made against this pledge. If the Second Circuit's new test correctly states the law, the criminal conviction in *Kendrick* could not have been sustained.[16]

2. *Seventh Circuit:* In *McGrath* v. *Zenith Radio Corp.*, 651 F.2d 458 (7th Cir.), *cert. denied,* 454 U.S. 835 (1981), misrepresentations concerning the future employment status of plaintiff caused him to waive an option agreement allowing him to purchase stock. Less than six months following such representations, plaintiff was fired. The Seventh Circuit upheld federal jurisdiction, despite the absence of fraud relating to the value of any stock, stating that the misrepresentations were "surely close enough to satisfy

16. *See also Arrington* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F.2d 615, 619 (9th Cir. 1981) (the fraud was "in connection with" the securities transactions when the misrepresentations concerned the risks of buying stocks on margin, and not the value of the stocks actually bought).

the touching or 'in connection with' requirement of section 10(b)'' under *Superintendent*. 651 F.2d at 467.

3. *Fifth Circuit*: In *Brown* v. *Ivie*, 661 F.2d 62 (5th Cir. 1981), *cert. denied*, 455 U.S. 990 (1982), the Fifth Circuit decided a case involving facts similar to *McGrath*. The alleged misrepresentations occurred in negotiations concerning an agreement that included a proivsion requiring plaintiff, a departing corporate officer, to sell his stock in the employer. The plaintiff was not told when accepting the agreement that there was an intention to oust him from his position. The Fifth Circuit reaffirmed that interpretation of the phrase ''in connection with'' was governed by *Superintendent*'s ''touching'' test. 661 F.2d at 65.

4. *Sixth Circuit*: In *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979), the Sixth Circuit also upheld a Rule 10b-5 claim, there based upon a broker's improper execution or non-execution of customer orders. Notwithstanding the lack of allegations of fraud relating to the value of the securities involved, the Court expressly applied *Superintendent*'s broad ''de minimis'' touch test. 598 F.2d at 1028.[17]

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17. The device used by the Second Circuit majority to avoid an appearance of conflict with precedent in other circuits was first to set up the "straw man" of *Weaver v. Marine Bank*, 637 F.2d 157 (3d Cir. 1980), *rev'd on other grounds*, 455 U.S. 551 (1982), as allegedly the closest case on point. The majority opinion then found that *Weaver* was distinguishable because the alleged misrepresentations there induced the plaintiffs to part with the pledged property (34a-35a), and relegated to a footnote its questionable analysis of other cases interpreting the phrase "in connection with", such as *Competitive Associates* and *A.T. Brod* (34a n.24). However, under the Second Circuit's new test below, the stated putative difference between *Weaver* and this case does not make for a legal distinction at all. The alleged fraud in *Weaver* still did not relate to the value of the pledged property, and there, as here, plaintiffs gave up value in connection with a pledge because of a fraudulent inducement. Nor were the other cases discussed by the Second Circuit majority distinguished in any more persuasive a manner. *See supra*, pp. 18-21.

IV. The Second Circuit's Decision Directly Conflicts With This Court's Rulings Concerning The Standards For Summary Judgment

In making the critical finding that "the pledge of the Elsters stock . . . was *merely* an *incident* in a transaction not otherwise involving the purchase or sale of securities" (34a n.24) (emphasis supplied), the majority (a) ignored facts, presented by the pleadings and uncontroverted affidavit evidence (facts which the majority had previously conceded), establishing that the August 1977 transaction was "one single, integrated refinancing package" (10a), and/or (b) chose between conflicting facts to rule against the party opposing summary judgment.

In either event, the majority opinion squarely conflicts with the standards established by this Court for the consideration of summary judgment motions: the allegations of a complaint and an affidavit opposing summary judgment must be taken as true, and all inferences must be drawn in favor of the party (here the Banks) opposing summary judgment. *See, e.g., United States* v. *Diebold, Inc.*, 369 U.S. 654, 655 (1962); *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 158-59 (1970).[18] This standard is no less rigorous for determining jurisdictional facts on summary judgment motions. *See, e.g., Steele* v. *Bulova Watch Co.*, 344 U.S. 280, 284 (1952); *Leasco Data Processing Equipment Corp.* v. *Maxwell*, 468 F.2d 1326, 1330 (2d Cir. 1972) ("[S]ubject matter jurisdiction . . . depend[s] on what the facts were.

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18. Indeed, in impermissibly refusing to accept the sworn-to facts as true and refusing to draw all inferences in favor of the Banks—much less in affirmatively drawing the adverse inference that the pledge was "merely an incident"—the majority appears to have been relying upon its own business judgment and its own erroneous doubts as to the value to the Banks of the pledge upon which the Banks had insisted in an arm's-length negotiation (33a & n.21).

[Plaintiff] at this stage would be entitled to every favorable inference'').[19]

In fact and law, the categorization of the pledge as merely ''incidental'' to the August 1977 transaction was clearly erroneous. As the dissent here pointed out, in order to hold that there was no fraud in connection with the pledge of the Elsters stock, the Second Circuit majority:

> of necessity, must disassociate the bailment of the stock from the underlying indebtedness which it secures. This . . . misconstrues the basic elements of a pledge . . . [T]he pledge and the debt secured by it are inseparable.

(42a n.2) (citations omitted). As a consequence, the dissent concluded, ''on the papers'' before the Second Circuit it was not proper to hold:

> that the pledge of the Elsters stock was a mere ''incident'' to the $4 million Elsters loan. If, as the majority correctly holds, a pledge is a ''sale'' for purposes of section 10(b), there is nothing about the pledge in the instant case that makes it more ''incidental'' than any other pledge.

(43a n.2).

The dissent correctly reminded the majority that because ''there was only one fraudulent scheme,'' the district court's acquisition of jurisdiction over part of such an integrated ''single seamless web''—a part which is directly related to the sale and purchase of a security (the pledge)—gave the district court a sound basis for disposing of the entire action (42a).

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19. That Andersen also moved to dismiss the Banks' complaint under Fed. R. Civ. P. 12(b)(1) and (6) is irrelevant. Andersen turned its Rule 12 motions into motions for summary judgment by submitting an affidavit and exhibits (13a), thus going well beyond the pleadings. *See* Fed. R. Civ. P. 12(c).

V. The Second Circuit's Decision That The Replacement Notes Are Not "Securities" Is In Conflict With This Court's Reasoning In *Securities Industry Association* v. *Board Of Governors*

The Replacement Notes provide an independent basis for federal jursdiction over the Banks' claim.[20] The district court held that such a "note" is a "security" within the meaning of both the 1933 and 1934 Acts (60a-61a) by applying the test of the Second Circuit set forth in *Exchange National Bank* v. *Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), and reaffirmed in *Golden* v. *Garafalo*, 678 F.2d 1139 (2d Cir. 1982).[21] That test emphasizes the statutory language: "security" is defined for the antifraud provisions of (a) the 1933 Act as including "any note" (regardless of duration) and (b) the 1934 Act as including a "note" with a maturity exceeding nine months, in each case "unless the context otherwise requires." Since, as the district court found, the Replacement Notes had a maturity of eleven months (60a n.21), they fell squarely within both statutory definitions of a "security."

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20. Questions related to the definition of a security under the federal securities laws have received frequent attention by this Court. In addition to cases cited *supra, see Tcherepnin* v. *Knight*, 389 U.S. 332 (1967) (withdrawable capital share in state-chartered savings and loan association is a security); *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946) (investment contract is a security); *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (investment contract is a security).

21. In *Exchange National Bank*, the Second Circuit, after reviewing the case law interpreting the definition of security provisions, decided that "the best alternative now available may lie in greater recourse to the statutory language". Thus, when a note has a maturity exceeding nine months, § 10(b) should be held to apply, unless "the context otherwise requires" (*i.e.*, when the note has a "strong family resemblance" to "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary cause of business . . .") (544 F.2d at 1137-38).

While the *Exchange National Bank* holding created certainty as to those statutory definitions, the Second Circuit in the instant case retreated to uncertainty by reversing. It held that the Replacement Notes were not securities, categorizing them as mere commercial loans extended for a borrower's "current operations" (24a). The Second Circuit so held despite its recognition that these notes were not instruments identified in *Exchange National Bank* as being outside the statutory definition of a "security" (*id.*), and thus in effect adopted the test of other circuits holding that a "note" is a security only when it evidences an "investment" transaction ("the commercial-investment dichotomy"). *See, e.g., McClure* v. *First National Bank,* 497 F.2d 490 (5th Cir. 1974), *cert. denied,* 420 U.S. 930 (1975).

However, this type of "commercial-investment" analysis is in direct conflict with the reasoning of this Court most recently announced in *Securities Industry Association* v. *Board of Governors,* 52 U.S.L.W. 4943 (U.S. June 28, 1984). There the Court held that commercial paper (classified as "notes") were "securities" because (1) they fell within the plain meaning of the Glass-Steagall Act's terms and (2) inclusion of such notes was fully consistent with that Act's underlying statutory purposes. The Court emphasized "the ordinary meaning of the statutory language" (52 U.S.L.W. at 4947) and rejected as a "nebulous inquiry" any analysis which concluded that only "investment" securities were covered by that Act (52 U.S.L.W. at 4944, 4947-48), thus, rejecting the rationale that the Second Circuit erroneously applied in this case. Although this Court did so in a case interpreting the definition of "securities" under a different statute, it nevertheless provides a beacon for guidance as to the scope of the federal securities laws' definitions of a "security" as they apply to notes. As the *Securities Industry* Court observed, the securities acts and the Glass-Steagall Act were collectively designed

(and drafted by the same Congressional committee at about the same time) to restore public confidence in financial markets and should be read together (52 U.S.L.W. at 4947).

The wisdom of adherence to the statutory language is amply illustrated here. By departing from the plain terms of the 1933 and 1934 Acts and essentially replacing Congress' language with its own commercial-investment gloss, the Second Circuit stripped the Banks of the protection that they fully merited under the securities laws.[22] According to the record here, the Replacement Notes bore no resemblance whatever to ordinary consumer-oriented commercial notes; the August 1977 transaction was anything but a routine, day-to-day financing of current operations. Rather the total financing provided by the August 1977 transaction represented some two-thirds of Frigitemp's total debt and 20% of its reported assets. The loans were, as the Second Circuit itself recognized, necessary because of Frigitemp's inability to raise funds in the traditional capital markets (8a n.2), and because without them Frigitemp would have gone bankrupt (32a). Thus, the financing at issue here *a fortiori* was as much the equivalent of equity capital as the notes ($1 million of notes representing a tiny fraction of debt and assets) determined to be securities by the Second Circuit in *Exchange National Bank.*[23]

Finally, the Second Circuit relied on this Court's decision in *Marine Bank* v. *Weaver,* 455 U.S. 551, 558 (1982), to support its restrictive reading of "security." But there,

22. One purpose of the antifraud provisions of the securities laws is to protect a "lender [who] parts with value and accepts securities as collateral security for a loan"—since the risk inherent in acceptance of such pledged stock is similar to that of an investor who also must rely on representations made to induce the purchase of equities. *Rubin* v. *United States,* 449 U.S. 424, 431 (1981).

23. *See also SEC* v. *Garfinkle,* [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,465 (S.D.N.Y. June 9, 1978); *Banco Nacional De Costa Rica* v. *Bremar Holdings Corp.,* 492 F. Supp. 364 (S.D.N.Y. 1980).

this Court held federally insured (and hence risk-free) certificates of deposits were not securities; such instruments are to be distinguished from uninsured long-term debt instruments in this case that Congress defined as securities.[24]

Conclusion

For the reasons stated above, a writ of certiorari should be issued to review the judgment of the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

PETER GRUENBERGER
Counsel of Record

IRWIN H. WARREN
PHILIP A. BYLER
RICHARD L. LEVINE
WEIL, GOTSHAL & MANGES
767 Fifth Avenue
New York, New York 10153
(212) 310-8000
Counsel for Petitioners
Manufacturers Hanover Trust Company
Security Pacific National Bank
First Pennsylvania Bank, N.A.

HAROLD R. TYLER, JR.
MICHAEL B. MUKASEY
ANN LOEB
PATTERSON, BELKNAP, WEBB, AND TYLER
30 Rockefeller Plaza
New York, New York 10112
(212) 541-4000
Counsel for Petitioner
Chemical Bank

August 17, 1984

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24. Significantly, *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982), was decided prior to *Golden* v. *Garafalo*, 678 F.2d 1139, 1144-46 (2d Cir. 1982), and *Seagrave Corp.* v. *Vista Resources, Inc.*, 696 F.2d 227, 230 (2d Cir. 1982), *cert. granted*, 52 U.S.L.W. 3827 (U.S. May 15, 1984) (No. 83-1084). In both latter cases, the Second Circuit rejected application of such restrictive catch-all tests as "commercial-investment" or "economic reality" in the note context.

APPENDICES

APPENDIX A

Rule 28.1 Statement of Petitioner Chemical Bank

Pursuant to Rule 28.1 of the Rules of the Supreme Court of the United States, Petitioner Chemical Bank submits the following statement. Chemical Bank has the following affiliates and subsidiaries: Albuquerque Capital Management, Inc.; Chemgraphics Systems, Inc.; Chemical Trust Company of Florida, N.A.; Chemical Mortgage Company; Chemical New York Southwest, Inc.; Chemical First State Corporation Chemical Bank (Delaware); Chemical New Jersey Corporation; Chemical Denver, Inc.; Chemical New York Corporation, USA; Chem Network Processing Services, Inc.; Investment and Capital Management Corp.; Investment & Capital Management of the South, Inc.; Sunamerica Corporation; Van Deventer and Hoch, Inc.; Favia, Hill & Associates, Inc.; Alexander, Scriver & Associates, Inc.; Chemco International Leasing, Inc.; Chemical New York Corporation, USA; Chemical New York Corporation, USA—Chemical Bank International, NA; Chemical New York Southwest, Inc.; Chemical Bank International, NA; Chemical Connecticut Corporation; Chemcredit SDN. BHD.; Far East Bank & Trust Co.; Chemical All-States Limited; Chemical Bank (Middle East) S.A.E.; Chemical International Finance and Consulting S.A./N.V.; Chemical Bank A.G.; Nordic; Banco General De Negocios, S.A.; Banco Noroeste De Investimento, S.A. and Noroeste—Chemical Leasing; Chemical Bank of Canada; Bank of New Providence Ltd.; Chemical Bank & Howard De Walden Ltd.; Chemco Finance Singapore Ltd.; Chemco Finance (Hong

Kong) Ltd.; Saehan Merchant Banking Corp.; Chemical Bank International Ltd.; P. T. Multinational Finance Corp.; Chemco Leasing Japan, Inc.; P. T. Chemco Graha Sejahtera Leasing.

Rule 28.1 Statement of Petitioner Manufacturers Hanover Trust Company

Pursuant to Rule 28.1 of the Rules of the Supreme Court of the United States, Petitioner Manufacturers Hanover Trust Company submits the following statement. Manufacturers Hanover Trust Company is wholly-owned by Manufacturers Hanover Corporation. The following are other subsidiaries of Manufacturers Hanover Corporation which either are not wholly-owned or have further subsidiaries (also listed) which are not wholly-owned: Manufacturers Hanover Leasing Corporation; Manufacturers Hanover Overseas Capital Corporation; Arrendadora Bancomer S.A. de C.V.; Arrendadora Banpesca S.A. de C.V.; P.T. Manufacturers Hanover Leasing Indonesia; Manufacturers Hanover de Arrendamento Finaciero, S.A. and Korea Industrial Leasing Co., Ltd. The following are the subsidiaries of Petitioner Manufacturers Hanover Trust Company which either are not wholly-owned or have furthur subsidiaries (also listed) which are not wholly-owned: Manufacturers Hanover International Finance Corporation; Manufacturers Hanover International Holdings Corporation; Manufacturers Hanover Bank Nordique; Manufacturers Hanover Holding (Delaware) Inc.; MH U.K. Holdings Ltd.; Anglo-Romanian Bank Ltd.; Anglo-Yugoslavia Ltd.; MH Bank Belgium; Bank Mendes Gans, N.V.; Adela Investment Co.; Banco Argentino de Inversion S.A.;

Banco de Guayaquil; Banque de L'Union Hartienne, S.A.; Compania Financiera Dominicana, S.A.; Corporacion Financiera Columbiana; Industrial Financial Corporation of Thailand; Industrialization Fund of Finland; Inversiones De Fomento Alcantara, S.A.; Malaysian Industrial Development Finance, Ltd.; National Investment Bank for Industrial Development, S.A.; Poliolefinas S.A. Industria E Commercio; Private Export Funding Corp.; Private Investment Company for Asia; P.T. Finconesia; Societe Internationale Financiere pour les Investissements et de Development en Afrique; Societe for Worldwide Interbank Financial Telecommunication; South East Asia Development Corp. Ltd. and Tokyo Lease Company, Ltd.

Rule 28.1 Statement of Petitioner First Pennsylvania Bank, N.A.

Pursuant to Rule 28.1 of the Rules of the Supreme Court of the United States, Petitioner First Pennsylvania Bank, N.A. submits the following statement. First Pennsylvania Bank, N.A. is wholly-owned by First Pennsylvania Corporation. All subsidiaries and affiliates are wholly-owned.

Rule 28.1 Statement of Petitioner Security Pacific National Bank

Pursuant to Rule 28.1 of the Rules of the Supreme Court of the United States, Petitioner Security Pacific National Bank submits the following statement. Security Pacific National Bank is wholly-owned by Security Pacific Corporation. The following are other subsidiaries of Security Pacific Corporation which either are not wholly-owned or

have further subsidiaries (also listed) which are not wholly-owned: Security Pacific Capital Markets Group, Inc.; Security Pacific Capital Markets (H.K.) Limited; Hoare Govett Limited; Security Pacific International Finance, Inc.; Japan Security Pacific Finance Company Limited; Seian Pacific, Ltd.; Security Pacific Video Services, Inc.; Videofinancial Services; Security Pacific Overseas Corp.; Security Pacific Do Brazil S/C L.T.D.A.; Security Pacific Overseas Investment Corporation; The Bank of Canton, Limited; Tricontinental Holdings Limited; Marac Holdings Limited; Security Pacific Capital Markets Group, Inc. International; Security Pacific S.A. (Switzerland); Palli Brothers (Bankers) S.A.

APPENDIX B

Opinion of the United States Court of Appeals for the Second Circuit, dated January 20, 1984 (726 F.2d 930)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 109—August Term 1983

(Argued: October 17, 1983 Decided: January 20, 1984)

Docket No. 83-7290

CHEMICAL BANK

Plaintiff-Appellee,

—against—

ARTHUR ANDERSEN & Co.,

Defendant-Appellant.

MANUFACTURERS HANOVER TRUST COMPANY and FIRST PENNSYLVANIA BANK, N.A.,

Plaintiffs-Appellees,

—against—

ARTHUR ANDERSEN & Co.,

Defendant-Appellant.

SECURITY PACIFIC NATIONAL BANK,
Plaintiff-Appellee,

—against—

ARTHUR ANDERSEN & CO.,
Defendant-Appellant.

Before:

FRIENDLY, VAN GRAAFEILAND and MESKILL,
Circuit Judges.

Appeal, pursuant to 28 U.S.C. § 1292(b), from parts of an order of the District Court for the Southern District of New York, Gerard L. Goettel, *Judge,* 552 F. Supp. 439 (1982). The order was made in actions against the public accounting firm of Arthur Andersen & Co. by four commercial banks which had made loans to Frigitemp Corporation and its wholly owned subsidiary, Elsters, Inc., the loan to Elsters being guaranteed by Frigitemp and secured by a pledge of all of Elsters' stock. The order denied Andersen's motion to dismiss or to grant summary judgment with respect to those portions of the complaint which alleged violations of the federal securities laws.

The Court of Appeals held (1) that renewal notes issued by Frigitemp were not securities within § 10(b) of the Securities Exchange Act of 1934 or § 17(a) of the Securities Act of 1933; and (2) that although the pledge of the Elsters stock was a sale and purchase of a security, Andersen's alleged knowing misrepresentations of Frigitemp's financial condition were not sufficient to make the transaction one in connection with the purchase and sale of a security since

Andersen was not alleged to have made any misrepresentations with respect to Elsters or its peldged stock. Accordingly, the order denying Andersen's motion was reversed.

Van Graafeiland, *Circuit Judge,* concurs in the first but dissents from the second holding, in an opinion.

FRIENDLY, *Circuit Judge:*

Arthur Andersen & Co. (Andersen) appeals, pursuant to 28 U.S.C. § 1292(b), from so much of an order of Judge Goettel in the District Court for the Southern District of New York, 552 F. Supp. 439 (1982), as denied its motion to dismiss the claims alleging violations of the federal securities laws in three actions brought by four commercial banks[1] which had made loans to Frigitemp Corporation (Frigitemp) and its wholly owned subsidiary, Elsters, Inc. (Elsters). The appeal raises important issues concerning the application of § 10(b) of the Securities Exchange Act of 1934 and the SEC's Rule 10b-5 and of § 17(a) of the Securities Act of 1933 to commercial bank loans evidenced by notes and, in one instance, secured by a pledge of a security.

Frigitemp was a publicly held company whose stock was listed on the American Stock Exchange. The company was primarily in the business of selling, manufacturing and installing interior furnishings in hotels, restaurants, institutions and ships. During the early and mid-1970's, Frigi-

1. Chemical Bank was the plaintiff in one action, Manufacturers Hanover Trust Company and First Pennsylvania Bank, N.A., were plaintiffs in a second, and Security Pacific National Bank was plaintiff in a third. The complaints are essentially the same, and the four banks joined in a single brief and argument. For convenience we shall generally refer to the case as a single action and to the four banks as the Banks.

temp embarked on a course of rapid expansion, acquiring a number of other companies. It acquired Elsters for stock on January 11, 1977, effective as of December 31, 1976. In the early 1970's Frigitemp financed its operations by obtaining various secured and unsecured credit lines extended by several institutions, including Manufacturers Hanover and Security Pacific National Bank. The company's rapid expansion over the next several years, however, required larger amounts of capital to sustain its operations. After having mixed success in forays into the public debt and equity markets,[2] Frigitemp looked to the Banks for financing.

By a contract dated December 31, 1975 (the Secured Credit Agreement), the Banks agreed to provide Frigitemp with a line of credit up to $8 million. Pursuant to the Secured Credit Agreement, the Banks advanced $6.5 million to Frigitemp beginning in 1976. The loans were evidenced by Frigitemp's promissory notes maturing on July 1, 1977, and were secured by a pledge of Frigitemp customer notes receivable.

In September, 1976, the Banks and Frigitemp began discussing the need to restructure Frigitemp's debt. Pending such restructuring, three banks in September, 1976 advanced $1.5 million evidenced by Frigitemp's one month promissory note to each bank; in October, 1976, they advanced an additional $3.5 million. Frigitemp gave each bank a promissory note maturing on February 28, 1977,

2. For example, in late 1971 Frigitemp entered the debt market by issuing approximately $2 million in subordinated convertible debentures. In the summer of 1973, however, Frigitemp's attempt to make a secondary offering of 250,000 shares of common stock was aborted by prevailing adverse market conditions and the deflated price of the stock at that time.

which included the $1.5 million owed on the September financing. This maturity was later extended to April 30, 1977. In February, 1977, Frigitemp received an additional $4 million unsecured loan from all four banks, evidenced by promissory notes also maturing April 30, 1977.

In addition to the loans evidenced by the $6.5 million of secured notes maturing July 16, 1977, and the $9 million of unsecured notes maturing April 30, 1977, Frigitemp had other financial needs. As described by the report of Worden & Risberg, management consultants,[3] Frigitemp, in the latter half of 1976,

> experienced a substantial buildup of trade payables due to cost incurred on customer-caused delays—for which they have not yet been reimbursed—and to a substantial increase in contract backlog—for which they had to begin placing purchase commitments. These factors have created a serious working capital deficit that is now affecting both vendor confidence and job completion.

One of the unsettling factors was a receivable of $11 million from Litton Industries, Inc.; the 1976 year-end financial statements of Frigitemp, certified by Andersen and dated May 10, 1977, recognized $8.9 million of this as income.[4]

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3. On May 10, 1977, the Banks decided to require Frigitemp to retain Worden & Risberg, management consultants, to report on Frigitemp and Elsters. The firm issued its report on June 28, 1977.

4. The 1976 statements in an explanatory note, however, mentioned the uncertainty surrounding the Litton claim:

> [F]or certain claims with a recognized revenue value of approximately $8,900,000, it is not possible at the present time to predict the amount of the ultimate settlement of such claims either by negotiation with the Company's customer or binding arbitration.

Andersen's Auditor's Report, attached to the statements, noted that "the ultimate realization of the claimed amounts [the Litton claim] recorded as of December 31, 1976, is not presently determinable."

However, the receivable remained unpaid and Frigitemp's working capital deficit was interfering with its ability to operate. Suppliers, for example, were beginning to hold up on deliveries. As the consultants' report concluded, and as the Banks realized, Frigitemp needed "approximately $4 million additional working capital to get through the current cash crunch it [was] experiencing." Frigitemp thus needed not only to refinance the $15.5 million owing under the Secured Credit Agreement and the unsecured loan transactions, but to obtain an additional $4 million. It sought to achieve this latter financing by a loan to its newly acquired subsidiary Elsters, as described below.

The restructuring transaction occurred in early August, 1977. Although evidenced by three different agreements, an officer of Manufacturers Hanover averred that these "were structured as, and were intended to be, part of one single, integrated refinancing package", and we shall assume for present purposes that this was the case.

Under one set of agreements, the Banks extended the maturity date of the $6.5 million of notes issued under the Secured Credit Agreement from July 1, 1977 to July 1, 1978; the notes were amended by endorsements dated August 9, 1977 (the Note Endorsements). Under a second set of agreements, substituting for the $9 million of unsecured notes which had become due on April 30, 1977, Frigitemp issued to the Banks the same amount of unsecured notes dated August 9, 1977 and maturing March 31, 1978 (the Replacement Notes). Finally, the Banks advanced $4 million to Elsters for which they received promissory notes dated August 8, 1977, maturing March 31, 1978; Frigitemp guaranteed these notes and pledged as security

100% of Elsters' common stock, 750 shares, pursuant to a Pledge and Security Agreement.

Frigitemp filed a petition in bankruptcy on March 20, 1978. By that time only approximately $4 million of the $15.5 million Frigitemp debt had been repaid.[5] At the same time Elsters ceased engaging in business. The Banks have realized some $2 million on the Elsters notes.

In this action, commenced in 1979, the Banks seek to hold Andersen and three principal officers of Frigitemp liable for their losses. The complaints allege that the Banks entered into the transactions with Frigitemp and Elsters in reliance on Frigitemp's financial statements audited and certified by Andersen for the years 1973-1976.[6] The Banks allege that Andersen knew that Frigitemp's financial statements were false and misleading in numerous respects, including the following: material overstatement of profits from long term contracts because of consistent understatement of the cost to Frigitemp of fulfilling such contracts; material overstatement of Frigitemp's income and current assets by inclusion of amounts claimed for material costs and work done as addition to or changes from specifications; and material overstatement of Frigitemp's accounts receivable by the inclusion of overbillings, of inclusion of unbilled and unbillable amounts, allocation of payments on current to older receivables, the $8.9 million Litton claim mentioned above, and other claims for work not performed. The first claim in the complaints alleges that in making such

5. The Banks realized approximately $1.6 million from the sale of Frigitemp's notes to third parties.

6. Andersen was not the auditor for Elsters and certified no financial statements for it.

certifications Andersen violated or aided and abetted in the violation of § 17(a) of the Securities Act of 1933,[7] § 10(b) of the Securities Exchange Act of 1934,[8] and Rule 10b-5 issued thereunder.[9] Three other claims in the complaints allege violations of state law.

7. Section 17(a) provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

8. Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

9. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(footnote continued on next page)

After answer and extensive discovery Andersen moved, in February, 1982, upon the affidavit of its counsel, Edward J. Ross, the exhibits submitted therewith, the pleadings and all the prior proceedings, for an order pursuant to Fed. R. Civ. P. 12(b)(1) and (6) and 56(b) dismissing the actions for lack of subject matter jurisdiction or, in the alternative, granting summary judgment in its favor on the claims pleaded under the federal securities laws, and, in either event, dismissing the pendent claims. In April, 1982, the Banks submitted an answering affidavit of one of their counsel, an affidavit of Richard J. O'Neill, a Vice-President of Manufacturers Hanover, who had been involved in the transactions between the Banks and Frigitemp, and a statement of material facts, pursuant to S.D.N.Y. Civ. R. 3(g). Mr. Ross submitted a further affidavit accompanied by numerous exhibits in May, 1982.

After receiving briefs and hearing argument, Judge Goettel filed a comprehensive opinion denying Andersen's motion, 552 F. Supp. 439 (S.D.N.Y. 1982). He first addressed the question whether any of the Frigitemp notes were securities within the pertinent provisions of the 1933 and 1934 Acts. He discussed the relevant authorities, particularly this court's decision in *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (1976). We

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(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

will analyze that decision in detail below; it is sufficient here to say that we noted that under the statutes, any note having a maturity exceeding nine months was a security under the 1934 Act and any note was a security under the antifraud provisions of the 1933 Act unless the context otherwise required. We proceeded to give many instances where the context did so require and said that:

> When a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply.

Id. at 1138 (footnote omitted). Judge Goettel held that the Note Endorsements, although having a maturity of more than nine months, "which were for a short term and which were secured by Frigitemp's customer notes receivable, bear a strong family resemblance to 'short-term notes secured by an assignment of accounts receivable,' " one of the examples cited in *Exchange National Bank,* and thus the context otherwise required that these not be considered securities within § 10(b) of the 1934 Act or § 17(a) of the 1933 Act. 552 F. Supp. at 448 (quoting *Exchange National Bank, supra,* 544 F.2d at 1138).

Turning to the Replacement Notes, Judge Goettel found that these bore no resemblance to any of the examples cited in *Exchange National Bank* and thus considered them to be securities for the purposes of § 17(a) of the 1933 Act, which had no provisions with respect to length of maturity. *Id.* He thought their status under the 1934 Act was not so clear because at the time of issuance they had a maturity of less than nine months, although, as he pointed out, "the actual effect of the Replacement Notes was to extend the

maturity date on the existing unsecured notes from April 30, 1977 until March 31, 1978, a period of eleven months," *id.* at 448 n.21, see also *id.* at 449. He concluded, however, that since under the "strong family resemblance" test the Replacement Notes would presumptively be securities under § 17(a) of the 1933 Act, it would make little sense to hold they were not securities under § 10(b) of the 1934 Act. *Id.* at 448-49. Finally, *id.* at 449-50, he rejected the argument that *Exchange National Bank* was no longer authoritative in the light of *Marine Bank v. Weaver,* 455 U.S. 551 (1982), citing our post-*Marine Bank* reaffirmation of *Exchange National Bank* in a different context in *Golden v. Garafalo,* 678 F.2d 1139, 1144-46 (2 Cir. 1982).

Judge Goettel then turned to the question whether the pledge of Elsters' stock would suffice to support jurisdiction over the federal securities laws claims even if the Replacement Notes were not securities. He thought it clear, citing *Rubin v. United States,* 449 U.S. 424, 431 (1981), and *United States v. Gentile,* 530 F.2d 461, 466-67 (2 Cir.), *cert. denied,* 426 U.S. 936 (1976), that a pledge of stock was a sale for purposes of § 17(a) of the 1933 Act and, citing *Mallis v. Federal Deposit Insurance Corp.,* 568 F.2d 824, 828-30 (2 Cir.), *cert. granted,* 431 U.S. 928 (1977), *cert. dismissed,* 435 U.S. 381 (1978), that it was a sale under § 10(b) of the 1934 Act. 522 F. Supp. at 450. He then addressed "[t]he question that has been debated by the parties", namely "whether the alleged fraud occurred 'in connection with' the pledge of Elsters stock." *Id.* at 450-51. He noted Andersen's argument that "because there was no misrepresentation or omission concerning the value of Elsters stock or Elsters' financial condition, the pledge of

Elsters stock cannot be used to sustain jurisdiction under section 10(b)," and the Banks' reply "that, to sustain jurisdiction under section 10(b), the fraud must merely 'touch upon' the sale, not relate to the value of the pledged securities." *Id.* at 451. The "touching" phrase comes from *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971), and the judge, although recognizing that "[p]erhaps the Supreme Court will, when confronted with the issue, narrow the test for determining whether the 'in connection with' requirement has been satisfied", thought himself bound by Supreme Court and Second Circuit precedent to hold that the "in connection with" requirement had been satisfied and that the pledge of the Elsters stock supported jurisdiction over the federal securities laws claims even if the Replacement Notes were not securities. 552 F. Supp. at 453-54.

The judge then reviewed and rejected other arguments of Andersen unnecessary here to describe. He ended his opinion by saying, 552 F. Supp. at 457-58:

> Although the Court believes that the present state of the law in this circuit precludes dismissal of the Banks' claims under the securities laws, it recognizes that there is substantial ground for difference of opinion on the jurisdictional questions—whether the Replacement Notes are securities and whether the pledge of Elsters stock is sufficient to support jurisdiction over this lawsuit. Because these are controlling legal questions, it appears that an immediate appeal from this decision will materially advance the ultimate termination of this litigation. Consequently, the Court will certify an interlocutory appeal on the jurisdictional questions pursuant to 28 U.S.C. § 1292(b)(1976),

and will stay further proceedings pending the outcome of the appeal.

A panel of this court granted leave to appeal.[10]

DISCUSSION

The Replacement Notes as Securities

In considering whether the Replacement Notes were securities within § 17(a) of the 1933 Act or § 10(b) of the 1934 Act, it will be useful, despite inevitable repetition, to begin with a full restatement of the statutory provisions[11] and a more extended summary of our opinion in *Exchange National Bank, supra.*

Under the 1933 Act, while § 2(1) provides that any note is a security unless the context otherwise requires, § 3(a)(3) expressly exempts from the registration and prospectus requirements "[a]ny note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the matu-

10. We think it proper to remind district judges that what 28 U.S.C. § 1292(b) authorizes is the certification that an "order involves a controlling question of law as to which there is substantial ground for difference of opinion", not the certification of questions as in 28 U.S.C. § 1254(3). See *Johnson v. Alldredge*, 488 F.2d 820, 822-23 (3 Cir. 1973), *cert. denied*, 419 U.S. 882 (1974). We thus would have been free, for example, to consider the ruling that the Note Endorsements were not securities if the Banks had asked us to do so.

11. A fuller statement of the history of these provisions is found in our *Exchange Nat'l Bank* opinion, *supra*, 544 F.2d at 1131-32 & nn.7-10.

rity of which is likewise limited." However, § 17, the general antifraud provision, specifies in subsection (c) that § 3 exemptions shall be inapplicable. In the 1934 Act Congress followed a different course. It provided, § 3(a)(10), that unless the context otherwise requires, "security" should include "any note" except that this would not include "any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

We began our discussion in *Exchange National Bank* by saying that "courts have shrunk from a literal reading [of these statutes] that would extend the reach beyond what Congress could reasonably be thought to have . . . intended in these two great pieces of legislation and would produce a seemingly irrational difference in the scope of their antifraud provisions." 544 F.2d at 1133. We then reviewed the only two cases in which this court had been required to decide whether notes constituted securities under the federal securities laws, *Movielab, Inc. v. Berkey Photo, Inc.*, 451 F.2d 661, 663-64 (1971) and *Zeller v. Boque Electric Manufacturing Corp.*, 476 F.2d 795, 799-800, *cert. denied*, 414 U.S. 908 (1973), in both of which we had held the notes there in question to be securities within the 1934 Act. We then examined cases in the Third, Fifth, Seventh and Ninth Circuits which had come to a contrary conclusion on the differing facts there presented and commented on the "commercial-investment dichotomy" propounded particularly in *McClure v. First National Bank*, 497 F.2d 490 (5 Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) and in *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7 Cir.),

cert. denied, 423 U.S. 825 (1975). We also took particular note of Judge Eugene Wright's narrower suggestion in a concurring opinion in *Great Western Bank & Trust v. Kotz,* 532 F.2d 1252, 1260-62 (9 Cir. 1976), that a note given to a commercial bank in what purports to be an exercise of its lending function is never a "security" within the 1933 or 1934 Acts.

Finding difficulties in these formulations, we suggested that it might be well to pay more heed to the statutory language than some courts had done.[12] Specifically we suggested:

> A party asserting that a note of more than nine months maturity is not within the 1934 Act (or that a note with a maturity of nine months or less is within it) or that any note is not within the anti-fraud provisions of the 1933 Act, has the burden of showing that "the context otherwise *requires.*"

544 F.2d at 1137-38 (emphasis in original; footnote omitted). We then suggested many cases where the context does so require. We mentioned, *id.* at 1138:

> the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized)[;]

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12. For example, Judge Roney conceded that his *McClure* opinion and other Fifth Circuit decisions virtually wrote out of the 1934 Act the distinction—seemingly drafted with care although without explanation of the reasons—between notes of more or less than nine months maturity. *McClure v. First Nat'l Bank, supra,* 497 F.2d at 494.

and went on to say that "[w]hen a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply," *id.* (footnote omitted).

Under the *Exchange National Bank* approach, our first question with respect to the status of the Replacement Notes as securities under the 1934 Act is to determine whether they had a maturity exceeding nine months. Andersen asserts that they did not since they were issued on August 9, 1977, and were payable on March 31, 1978, and the district judge seemingly accepted that assertion although pointing out, as previously stated, that "the actual effect of the Replacement Notes was to extend the maturity date on the existing unsecured notes from April 30, 1977 until March 31, 1978, a period of eleven months," 552 F. Supp. at 448 n.21, see also *id.* at 449.

Decision of this question turns on whether Congress intended to apply the same test to the renewal of a note as it did to the original issuance. With respect to the latter it does seem clear that the date of issuance is critical. For example, a note issued on April 1 and maturing October 15 would fall within the exception even though the indebtedness, as evidenced, e.g., by an overdraft or book entry, had been incurred on and the note was dated as of January 1. What is not so clear is whether the same rule applies to the renewal of a note. It can be argued that the word "likewise" in the final clause of § 3(a)(3) picks up the entire phrase "a maturity at the time of issuance of not exceeding nine months". On the other hand, it can be contended that the term "likewise" embraces only the words "a maturity of not exceeding nine months" since, as indicated by the district court, it makes little business sense to exclude a

period when renewed notes were still outstanding but overdue.[13] Moreover, unless the renewal clause is not construed, it is difficult to see what function it serves. However, even if we assume *arguendo* that the Replacement Notes had a maturity exceeding nine months and thus are not within the exception of § 3(a)(10) of the 1934 Act, we hold, in contrast to the district judge's understandable reading of *Exchange National Bank,* that the context requires that they not be considered securities within § 10(b) of the 1934 Act.

Andersen assails *Exchange National Bank* as a literalist approach to the definition of a security, running counter in this respect to *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, 848-51 (1975) (stock representing shares in cooperative apartment not within the meaning of the securities laws) and *International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551, 557, 558 n.11 (1979) (certificate of interest in non-contributory compulsory pension plan not a security within the meaning of the securities laws). *Forman* was decided prior to *Exchange National Bank* and was carefully considered therein, 544 F.2d at 1137; *Daniel* added nothing of substance so far as this case is concerned. Moreover, despite the pejorative label attached by some courts, *see, e.g., Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.,* 583 F.2d 426, 431 n.6 (9 Cir. 1978); *Union Planters National Bank v. Commercial Credit Business Loans, Inc.,* 651 F.2d 1174, 1180 n.7 (6 Cir.), *cert. denied,* 454 U.S. 1124 (1981); *Baurer v. Planning Group, Inc.,* 669 F.2d 770, 776 (D.C. Cir. 1981), and commentators, *see, e.g.,* Sonnenschein, *Federal Securities Law Coverage of Note Transactions:*

13 . The anomaly would be still greater if the initial notes had a maturity exceeding nine months and were renewed for another period exceeding nine months but the date of renewal was such that less than nine months expired between that date and maturity.

The Antifraud Provisions, 35 Bus. Law. 1567, 1601 (1980), we do not regard *Exchange National Bank* as taking a "literalist" or even a "neo-literalist" approach. Its position was and is that the words of the statute are not to be disregarded, as some other approaches have done, see *supra* note 12, but are to be given significance "unless the context otherwise requires." This is the same approach we have taken with respect to the "sale of business" doctrine, where we have respectfully disagreed with the more freewheeling view of the Seventh Circuit in *Frederiksen v. Poloway,* 637 F.2d 1147, *cert. denied,* 451 U.S. 1017 (1981), adhered to in *Sutter v. E.B. Groen,* 687 F.2d 197 (7 Cir. 1982). See *Golden v. Garafalo, supra,* 678 F.2d 1139, 1145, expressly approving the reasoning in *Exchange National Bank.*

However, language in *Marine Bank v. Weaver, supra,* 455 U.S. 551, does cast some doubt on whether *Exchange National Bank* can properly be applied so as to hold the Replacement Notes to be securities under § 10(b), even assuming that they have a maturity of more than nine months. We say language because the actual holdings of *Marine Bank,* namely, that neither the pledge of a six year bank certificate of deposit which was insured by the Federal Deposit Insurance Corporation as security for a loan to a business corporation nor an agreement by the owners of the corporation with the pledgors of the certificate and the guarantor of the loan constituted a security for the purposes of the antifraud provisions of the federal securities laws, *id.* at 559-60, are in no way counter to *Exchange National Bank.* Nevertheless, we cannot fail to take note of the Court's statement, *id.* at 556, after quoting the "if the context otherwise requires" language:

> Moreover, we are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad

> federal remedy for all fraud. *Great Western Bank & Trust v. Kotz,* 532 F.2d 1252, 1253 (CA9 1976); *Bellah v. First National Bank,* 495 F.2d 1109, 1114 (CA5 1974)[;]

and its footnote 10, *id.* at 560, reading:

> Cf. *Great Western Bank v. Kotz,* 532 F.2d 1252, 1260-1262 (CA9 1976) (Wright, J., concurring) (unsecured note, the terms of which were negotiated face-to-face, given to a bank in return for a business loan, is not a security).[14]

We are impressed also by the Banks' failure to cite any appellate decision, despite Andersen's challenge to do so, in which a note evidencing a loan made by a commercial bank to finance current operations of a borrower has been held to constitute a security within the federal securities laws.[15] Indeed, the case law on this point outside this Circuit is squarely against the Banks' position. *See, e.g., Bellah v. First National Bank,* 495 F.2d 1109, 1114 (5 Cir. 1974); *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra,* 508 F.2d 1354, 1362; *Great Western Bank & Trust v. Kotz, supra,* 532 F.2d 1252; *American Bank & Trust Co. v. Wallace,* 702 F.2d 93, 97 (6 Cir. 1983).

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14. The Court cited Judge Wright's opinion in *Great Western Bank & Trust* in footnote 10 as supporting authority for its holding that the "agreement, negotiated one-on-one by the parties, is not a security." 455 U.S. at 560. According to the recognized guide to legal citation method and style, popularly known as the "Blue Book," the introductory signal *"Cf."*, although literally meaning "compare," indicates that the cited authority "supports a proposition different from the main proposition but sufficiently analogous to lend support." A Uniform System of Citation 9 (13th ed. 1981). Thus, the Court's reference to Judge Wright's concurring opinion must be regarded as an approving one.

15. *Exchange Nat'l Bank* was not such a case, for reasons developed in the opinion, 544 F.2d at 1138-39.

The examples in *Exchange National Bank* of notes which, even though not falling within the less than nine months maturity exception of § 3(a)(10) of the 1934 Act, could not properly be regarded as securities, were not graven in stone, as evidenced by our remark that "[w]hen a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should *generally* be held to apply." 544 F.2d at 1138 (emphasis supplied; footnote omitted). We do not overrule the approach of *Exchange National Bank* that in the case of a note with a maturity exceeding nine months, the person asserting that the note is not a security within § 10(b) has the burden of demonstrating that the context otherwise requires. We simply add notes evidencing loans by commercial banks for current operations to the categories previously listed. By the same token such a note does not fall within § 17(a) of the 1933 Act, and it becomes unnecessary to consider whether Andersen participated "in the offer or sale" of the Replacement Notes as that section requires.

Whether the pledge of the Elsters stock brings the August 1977 restructuring within the federal securities laws

While vigorously contending that the Replacement Notes were securities, the Banks rely even more strongly on Judge Goettel's holding that Frigitemp's pledge of 100% of the stock of Elsters was a sale of a security by Frigitemp and a purchase by the Banks, that for this reason any misrepresentation by Andersen with respect to the financial condition of Frigitemp was "in connection with the purchase or sale of any security" under § 10(b)

and Rule 10b-5, and that the entire August 1977 restructuring thus falls within these provisions.

Andersen's initial brief did not directly challenge the proposition that a pledge is a sale and purchase of a security under § 10(b), as we squarely held in *Mallis v. Federal Deposit Insurance Corp., supra,* 568 F.2d at 830. However, Andersen's reply brief contains some intimations that *Mallis* was adversely affected by *Rubin v. United States, supra,* 449 U.S. 424, and that the contrary position taken in *McClure v. First National Bank, supra,* 497 F.2d 490, 495-96, *National Bank of Commerce v. All American Assurance Co.,* 583 F.2d 1295, 1300 (5 Cir. 1978), and *Lincoln National Bank v. Herber,* 604 F.2d 1038, 1044 (7 Cir. 1979), is correct.[16] We see no reason to disavow *Mallis.*

The predicate for Andersen's argument is the narrow basis on which Chief Justice Burger placed the Court's decision in *Rubin v. United States, supra,* that a pledge was an offer or sale under § 17(a) of the 1933 Act. He began by noting the definition in § 2(3) of "offer" and "sale" used in § 17(a) of the 1933 Act:

> 'The term "sale" or "sell" shall include every contract of sale *or disposition* of a security *or interest in a security,* for value. The term . . . "offer" shall include every *attempt or offer to dispose of,* or solicitation of an offer to buy, a security *or interest in a security,* for value.'

449 U.S. at 429 (emphases supplied by Supreme Court). The Chief Justice then emphasized, *id.*, that "[a]lthough pledges transfer less than absolute title, the interest thus

16. Other circuits have agreed with *Mallis.* See *Mansbach v. Prescott, Ball & Turben,* 598 F.2d 1017, 1028-29 (6 Cir. 1979); *Weaver v. Marine Bank,* 637 F.2d 157, 163 (3 Cir. 1980), *rev'd on other grounds,* 455 U.S. 551 (1982); *United States v. Kendrick,* 692 F.2d 1262, 1265 (9 Cir. 1982), *cert. denied,* 103 S. Ct. 1892 (1983).

transferred nonetheless is an 'interest in a security,' " and added that "[i]t is not essential under the terms of the Act that full *title* pass to a transferee for the transaction to be an 'offer' or a 'sale,' " *id.* at 430 (emphasis supplied).

Andersen's point is that since §§ 3(a)(13) and (14) of the 1934 Act do not include the words "or interest in a security", the *Rubin* opinion inferentially excludes a pledge from coverage under that Act. Arguably a fear of such a result is what led Justice Blackmun to concur only in the *Rubin* judgment and to place his concurrence on the simple ground that a pledge was a type of "disposition" covered by § 2(3) of the 1933 Act, citing this court's decision in *United States v. Gentile, supra,* 530 F.2d 461, 466, a provision for which there was a parallel in § 3(a)(14) of the 1934 Act. 449 U.S. at 431-32 (Blackmun, J., concurring in judgment).

If this was Justice Blackmun's fear, the Court moved swiftly to allay it in a footnote to *Marine Bank v. Weaver, supra,* 455 U.S. at 554 n.2, also written by the Chief Justice. There the Third Circuit had held that a pledge of a certificate of deposit as guarantee for a loan was a sale of a security within § 10(b) of the 1934 Act. *Weaver v. Marine Bank,* 637 F.2d 157, 163-64 (3 Cir. 1980). While, as indicated above, the Supreme Court reversed on the ground that the certificate of deposit was not a security, 455 U.S. at 558-59, the Court stated with regard to the issue whether a pledge fell within § 10(b):

> The Court of Appeals also concluded that the pledge of a security is a sale [within § 10(b)], an issue on which the federal Circuits *were* split. We held in *Rubin v. United States,* 449 U.S. 424 (1981), *that a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws.*

> Accordingly, in determining whether fraud may have occurred here "in connection with the purchase or sale of any security," the only issue now before the Court is whether a *security* was involved.

455 U.S. at 554 n.2 (final emphasis in original; other emphases supplied). Although this may be dictum given the Court's conclusion that the transaction at issue did not involve a security, it is certainly considered dictum, particularly in view of the Chief Justice's authorship of both opinions, and dispels any negative inference with respect to the § 10(b) problem from the emphasis on "interest in a security" that might otherwise arise from the *Rubin* opinion.[17]

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17. The legislative history also dispels any notion that significance should be attached in the present context to the omission of the phrase "an interest in a security" from the definitional sections of the 1934 Act. The original draft of the 1934 Act, S. 2693, 73d Cong., 2d Sess. § 3.12 (Feb. 9, 1934), provided:

> The terms "sale" and "sell" each include any contract of sale or disposition of, contract to sell or dispose of, attempt or offer to dispose of, or solicitation of or offer to buy a security or any interest therein.

This proposed language tracked that of § 2(3) of the 1933 Act. The final version of this bill, which was presented as a new bill, S. 3420, 73d Cong., 2d Sess. § 3(a)(14) (Apr. 20, 1934), and was enacted after the Senate and House conferees combined it with the House's companion legislation, pared down the language and provided simply:

> The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

While the relevant Senate hearings, debates and committee reports do not show the reason for this change of language, the proceedings in the House shed a glimmer of light.

The first bill presented to the House, H.R. 7852, 73d Cong., 2d Sess. § 3.12 (Feb. 10, 1934), was identical to its counterpart introduced the day before in the Senate, S. 2613, *supra*. Several weeks later, after conducting hearings, H.R. 8720, 73d Cong., 2d Sess. § 3(a)(15) (Mar. 19, 1934) was introduced. This bill contained the language that the Senate adopted in its final bill, S. 3420, *supra*, and

(footnote continued on next page)

With this much established, we are ready to consider Andersen's more serious point with respect to the pledge of the Elsters stock. This is that the complaint does not allege that Andersen made any misrepresentation concern-

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that ultimately became part of the legislation. Section 3(a)(15) of H.R. 8720, *supra*, provided:

> The terms "sale" and "sell" each include any sale or any contract to sell or otherwise dispose of.

This language remained part of the final version of the House bill, see H.R. 9323, 73d Cong., 2d Sess. § 3(a)(14) (Apr. 25, 1934).

A careful review of the relevant House debates, hearings and committee reports shows that the House's decision to omit the final clause of § 3.12 of H.R. 7852, *supra* (the original House bill), from § 3(a)(14) of its final version, H.R. 9323, *supra*, was indeed an attempt to narrow the definition of "sale," but only with regard to unconsummated attempts to acquire and offers to sell or purchase securities. There are no indications that the House intended to exclude transactions which, like pledges, include dispositions of securities.

The evidence for this is a statement of John M. Hancock, an influential member of the investment banking firm of Lehman Brothers. On March 2, 1934, Mr. Hancock appeared before the House Committee on Interstate and Foreign Commerce, the committee which was considering H.R. 7852 and 8720, *supra*. In an appendix to his written statement submitted to the committee, Mr. Hancock commented that §§ 3.11 and 3.12 of H.R. 7852, *supra*,

> have very broad definitions for the words "buy" and "sell", "buy" including an attempt to acquire an offer to sell, and "sell" including an attempt to secure an offer to buy. This makes a mere conversation have the same legal effect as the action resulting from this conversation.

Stock Exchange Regulation: Hearing before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. (1934) (statement of John M. Hancock), *reprinted in* 9 Legislative History of The Securities Act of 1933 and Securities Exchange Act of 1934, at 493 (J.S. Ellenberger & E. Mahar eds. 1973). Evidently, the committee agreed with Mr. Hancock's concern and responded by deleting the troublesome language from the bill. See H.R. 8720, *supra*. In so doing, however, the committee, apparently as a result of drafting technique, also deleted the "interest in a security" language that had been part of the final clause containing the "attempt" language. Thus, the Committee's omission of the "interest in" a security language appears to have been only a drafting response to a suggestion aimed at an entirely different problem.

ing Elsters.[18] Andersen contends, correctly so far as we have been able to ascertain, that all the cases imposing liability for violations of § 17(a) of the 1933 Act or § 10(b) of the 1934 Act or Rule 10b-5, in respect of pledges, are cases where the defendant committed a proscribed act with respect to the pledged securities. *See, e.g., United States v. Gentile, supra,* 530 F.2d 461, 466-67; *Mallis v. Federal Deposit Insurance Corp., supra,* 568 F.2d 824, 826-27; *United States v. Kendrick,* 692 F.2d 1262, 1265-66 (9 Cir. 1982), *cert. denied,* 103 S. Ct. 1892 (1983); *Bradford Securities Processing Services, Inc. v. County Federal Savings & Loan Association,* 450 F. Supp. 208, 209-10 (S.D.N.Y. 1978). It argues therefore that even if it made any untrue statement of a material fact with respect to Frigitemp or omitted to state a material fact concerning Frigitemp necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, this was not "in connection with" the Banks' "purchase" or Frigitemp's "sale" of the Elster's stock by way of the pledge to secure the $4,000,000 loan made to Elsters. The Banks' principal answer is that the Elsters loan was guaranteed by Frigitemp; that misrepresentations with respect to Frigitemp thus affected the entire Elsters transaction since Frigitemp's guarantee was less valuable than the Banks had thought and they would have to rely more heavily on the pledged Elsters stock; and that since all three

18. In response to an interrogatory propounded by Andersen whether Chemical asserted "that any information it received as to the business or financial condition of Elsters, Inc. was in any respect untrue or misleading or omitted to state any fact necessary to make such information not untrue or misleading", Chemical answered that it had no facts to support any such assertion but reserved the right to make such an assertion if discovery or other information subsequently obtained should reveal a basis for it. Jt. App. at 204.

of the August, 1977 transactions were integrated and the Elsters loan involved the purchase or sale of a security, the misrepresentations affected all.

Section 10(b) of the 1934 Act was obviously drawn from § 17(a) of the 1933 Act; its principal effect (apart from the much debated question of the existence of an implied private cause of action for damages under § 17(a)) was to cover frauds practiced on the seller as well as on the buyer. The legislative history sheds no light why Congress instead of simply expanding "in the offer or sale" phraseology of § 17(a) to read "in the offer, sale or purchase," adopted the "in connection with the purchase or sale" phraseology of § 10(b). Although arguably "in connection with" has a somewhat broader sweep than "in", it may be just as true that the "in connection with" phraseology simply fit better with the rest of § 10(b). *Cf. United States v. Naftalin,* 441 U.S. 768, 773 n.4 (1979) (The Court is "not necessarily persuaded that 'in' is narrower than 'in connection with.' ").[19] Courts sometimes err in attributing substantive importance to what may well have been only a draftsman's choice of slightly different language. As Judge Posner has observed, "Omniscience is always an unrealistic assumption, and particularly so when one is dealing with the legislative process." *Statutory Interpretation—in the Classroom and in the Courtroom,* 50 U. Chi. L. Rev. 800, 811 (1983). Professor Loss has recently stated that the "in connection with" phrase "is not the least difficult as-

19. In support of its statement that the two terms had been used interchangeably, the Court pointed to Justice Douglas' opinion in *Superintendent of Insurance v. Bankers Life & Casualty Co., supra,* 404 U.S. at 10, discussed *infra,* where shortly after quoting the "in connection with" language of § 10(b), Justice Douglas said, "For § 10(b) bans the use of any deceptive device *in* the 'sale' . . . ." (Emphasis supplied).

pect of the 10b-5 complex to tie down." Fundamentals of Securities Regulation 903 (1983).

The difficulty has been somewhat increased by Justice Douglas' reference, in the Supreme Court's first brush with Rule 10b-5, to the plaintiff's having "suffered an injury as a result of deceptive practices *touching* its sale of securities as an investor." *Superintendent of Insurance v. Bankers Life & Casualty Co., supra,* 404 U.S. 6, 12-13 (emphasis supplied). We are inclined to agree with Professor Loss, that "there is no reason to believe that the Justice's use of 'touching' was anything more than his variation of 'in connection with' as a matter of literary style." Loss, *supra,* at 903-04. There is no need for us to recapitulate the oft-described complex facts of the *Superintendent of Insurance* case. It suffices to point out that the Court had found, long before the "touching" reference, that "[t]here certainly was an 'act' or 'practice' . . . which operated as a 'fraud or deceit' on Manhattan, the seller of [securities]", in that although "the full market price was paid for these bonds . . . the seller was duped into believing that it, the seller, would receive the proceeds." 404 U.S. at 9. Thus, the Court had concluded that "Manhattan was injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities." *Id.* at 10.

A leading treatise on § 10(b) and Rule 10b-5 suggests that the "connection" between fraud and a securities transaction "can be very tenuous," 2 Bromberg & Lowenfels, Securities Fraud & Commodities Fraud § 4.7(574)(3), at 88.34 (1982), a phrase which this court quoted in *United States v. Newman,* 664 F.2d 12, 18 (1981), *judgment following remand affirmed by unreported order,* No. 82-1273 (Feb.

8, 1983), *cert. denied,* 52 U.S.L.W. 3240 (Oct. 3, 1983) (No. 82-1653),[20] see also Note, *The Pendulum Swings Farther: The "In Connection With" Requirement and Pretrial Dismissals of Rule 10b-5 Private Claims for Damages,* 56 Tex. L. Rev. 62 (1977). However, statements to this effect have usually been made in cases like *Newman* where the connection was anything but tenuous. In cases near the borderline, courts have warned that "[i]t is important that the standard be fleshed out by a cautious case-by-case approach." *Smallwood v. Pearl Brewing Co.,* 489 F.2d 579, 595 (5 Cir.) (Wisdom, J.), *cert. denied,* 419 U.S. 873 (1974). *Accord, Ketchum v. Green,* 557 F.2d 1022, 1027 (3 Cir.) (Adams, J.), *cert. denied,* 434 U.S. 940 (1977). We ourselves have stated that *Superintendent of Insurance* "pushed the perimeters rather far," *IIT v. Vencap, Ltd.,* 519 F.2d 1001, 1014 n.26 (2 Cir. 1975).

As earlier stated, in August, 1977, Frigitemp not only was unable to repay the $6.5 million of secured notes and the $9 million unsecured notes but needed $4 million more. The Banks had to decide whether to let Frigitemp go under or to make the loans needed to keep it afloat and hopefully to survive. The complaints adequately allege that in deciding to renew the loans to Frigitemp and to loan $4 million to Elsters guaranteed by Frigitemp, the Banks relied on information concerning Frigitemp furnished by Andersen with knowledge of its falsity. This, however, would not bring the transaction within § 10(b) and Rule 10b-5 since neither the notes nor the guarantee were a "security." Does the case come within it because the Banks also ob-

20. This seems to be the only occasion in which a court has quoted the phrase.

tained a pledge of 100% of the stock of Elsters[21] when there is no allegation that Andersen, which had never been Elsters' auditor, misrepresented the value of Elsters or its stock? In *Rubin, supra,* 449 U.S. at 429 n.6, the Supreme Court stated that it "need not decide whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a)."[22] We are here compelled to decide that question, with respect to § 10(b) and Rule 10b-5 as well as § 17(a); our answer is in the negative.

The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived in securities transactions—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be. Andersen is not alleged to have deceived the Banks with respect to the pledge of the Elsters stock; the Banks got exactly what they expected.

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21. At first blush it is hard to see what added security a lender obtains by a pledge of the stock of the borrower when it already has a claim against the borrower's assets ranking prior to the stock. However, in an answer to an interrogatory, Chemical averred that "[b]anks commonly take the stock of a company as collateral in order to obtain additional protection," which itself tells us nothing, and that it was felt "that, in the event of default, recovery realized on the foreclosure and sale of the equity would be higher than that realized on piecemeal foreclosure and sale of various assets of Elsters." Jt. App. at 205.

22. In the light of this express disclaimer we are unable to understand what comfort our dissenting brother derives from *Rubin* on the point here at issue.

We do not question that the complaint stated a claim of common law fraud with regard to the Elsters loan since the misrepresentations relating to Frigitemp affected its guarantee. But this is irrelevant to the issue whether Andersen is liable under § 10b of the 1934 Act or § 17a of the 1933 Act when it made no misrepresentation as to the only "security" involved in the transaction, to wit, the Elsters stock.

Their showing is simply that but for Andersen's description of Frigitemp they would not have renewed the Frigitemp loans or made the Elsters loan which Frigitemp guaranteed, and that if they had not done this, there would have been no pledge of Elsters' stock. Such "but-for" causation is not enough.[23] The Act and Rule impose liability for a proscribed act in connection with the purchase or sale of a security; it is not sufficient to allege that a defendant has committed a proscribed act in a transaction of which the pledge of a security is a part.

None of the many cases relied on by the Banks, *e.g., Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath,* 516 F.2d 811, 812-13 (2 Cir. 1975); *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 651 F.2d 615, 619 (9 Cir. 1981); and *United States v. Newman, supra,* 664 F.2d 12, 18, goes so far as they would take us here.[24] Perhaps the closest is the decision of a divided

23. Borrowing the phraseology this court used in *Schlick v. Penn-Dixie Cement Corp.,* 507 F.2d 374, 380 (2 Cir. 1974), *cert. denied,* 421 U.S. 976 (1975), the Banks' "but-for" allegation merely established "transaction causation." As described below, they have failed to establish the "loss causation" necessary for a legally sufficient claim under § 10(b) and Rule 10b-5.

24. *Arrington v. Merrill Lynch* was a classic case of misrepresentation by a broker with respect both to the specific securities being purchased and to the lack of risk in margin buying. *Competitive Associates* involved misrepresentation by an accounting firm with respect to an investment fund through which plaintiff intended to and did engage in massive trading in securities. In *United States v. Newman,* a criminal prosecution for insider trading, we found that "appellee's sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies", 664 F.2d at 18—obviously securities. In *A.T. Brod & Co. v. Perlow,* 375 F.2d 393, 397 (2 Cir. 1967), particularly relied on by the dissent, there was no question that the Perlows' fraud (placing orders for securities with the fraudulent intent of paying only if those had appreciated by the time payment was due) was in connection with the purchase and sale of securities. Here the pledge of the Elsters stock, as to which no fraud is alleged, was merely an incident in a transaction not otherwise involving the purchase or sale of securities.

panel in *Weaver v. Marine Bank,* 637 F.2d 157, 159-60 (3 Cir. 1980), *rev'd on other grounds,* 455 U.S. 551 (1982). There the misrepresentations of the bank with respect to the Columbus Packing Co. allegedly induced the plaintiffs to make a pledge to a bank of a certificate of deposit, which the Third Circuit considered a security, in order to procure a bank loan to that company[25] in whose profits the plaintiffs were to share. Whether or not that case would have been correctly decided if the pledged certificate of deposit had been a security, it would not control here. The alleged misrepresentations in *Weaver* induced the plaintiffs to part with the pledged property; here the alleged misrepresentations simply induced the Banks to make loans collateralized by a pledge of a security as to which no misrepresentations were made. In order for this case to be ruled by the Third Circuit's decision in *Weaver,* one would have to change the facts so that because of Andersen's alleged misrepresentations concerning Frigitemp, the Banks released securities previously pledged to them by Frigitemp. We cannot believe that if a person misrepresents his financial condition in order to borrow $100,000 from a bank to which he gives a one month note partially secured by a pledge of GM stock, the case comes within § 10(b) and Rule 10b-5, although but for the pledge it would not. Yet this seems the inevitable consequence of the Banks' position here.[26] While,

25. The court considered, erroneously as matters turned out, that the profit sharing agreement was itself a security, and the "in connection with" discussion was in that context, see 637 F.2d at 164.

26. The dissent does not deal satisfactorily with this hypothetical. Its position, that a misrepresentation by a borrower with respect to a loan which is not itself a security renders the transaction subject to § 10(b) and Rule 10b-5 if it also involves a pledge, would cover the hypothetical. Indeed, the pledge of the GM stock would have been more important to the hypothetical transaction than the pledge of the

(footnote continued on next page)

as the Banks argue, the misrepresentations as to the borrower's financial condition would require greater resort to the GM stock, and result in greater loss to the extent that the loan was not fully repaid, this is not enough to make the misrepresentations in connection with the purchase or sale of a security. It would be anomalous to hold that commercial bank loans procured by fraud are generally not within § 10(b) and Rule 10b-5, but that they become so, even though of a sort that no one would have considered to constitute a security, if collateralized with a security, although no misrepresentation was made with respect to the latter. It would be even more anomalous to hold that alleged misrepresentations concerning Frigitemp but not Elsters subject Andersen to liability for transactions, those involving the Note Endorsements and the Replacement Notes, in which no security played a part. Since the standard for connection imposed by § 17(a) of the 1933 Act is at least as high as that of § 10(b) and Rule 10b-5, it is unnecessary to discuss the question, which the Supreme Court has thrice declined to decide, see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 n.6 (1975); *Aaron v. SEC*, 446 U.S. 680, 689 (1980); *Herman & MacLean v. Huddleston*, 103 S. Ct. 683, 685 n.2 (1983), whether there is a private right of action for damages under that section.

We thus hold that the Replacement Notes were not securities under § 10(b) of the 1934 Act or § 17(a) of the 1933 Act and that while the pledge of the Elsters stock

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stock of the borrower in this case, see *supra* note 21. Admittedly, the bank in the hypothetical would have had better ways of evaluating the GM stock than the Banks here had with respect to the Elsters stock. But the point remains that Andersen is not charged with having made or aided or abetted the making of any false representations about the Elsters stock.

was a sale of a security by Frigitemp and a purchase by the Banks, Andersen's alleged misrepresentations concerning Frigitemp (but not Elsters) were not in connection with the sale or purchase of the Elsters stock under § 10(b) of the 1934 Act and Rule 10b-5 issued thereunder or in the offer or sale of a security under § 17(a) of the 1933 Act. Since the first claims in the complaints must thus be dismissed for failure to allege violations of the federal securities laws, it would seem that the remaining claims must be dismissed under the principles laid down in *United Mine Workers v. Gibbs,* 383 U.S. 715 (1966). However, since the district court did not reach that issue, we leave the question for determination by it. No costs.

VAN GRAAFEILAND, *Circuit Judge,* concurring and dissenting:

I concur in Judge Friendly's customary well-reasoned opinion, except for that portion which holds as a matter of law that Arthur Andersen & Co. did not violate section 10(b). As to that portion I respectfully dissent. Because Arthur Andersen & Co. is alleged to be an aider and abettor of Frigitemp Corporation, discussion of the issue which prompts this dissent will be simplified by assuming that Frigitemp rather than Arthur Andersen is the defendant.[1]

In 1977, Frigitemp numbered among its assets 750 shares of Elsters, Inc., which was all the common stock of that wholly owned subsidiary. In August of that year, Frigitemp "sold" that stock to appellee banks within the meaning of section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b). *See Mallis v. Federal Deposit Ins. Corp.,* 568 F.2d 824, 830 (2d Cir.), *cert. granted,* 431 U.S. 928 (1977), *cert. dismissed as improvidently*

1. Suit against Frigitemp was precluded by its bankruptcy.

granted, 435 U.S. 381 (1978). Although Elsters' stock was not traded on any exchange and had no accurately ascertainable market value, appellees loaned Elsters $4 million as their part of the "sales" transaction. We have no way of knowing how much the banks would have loaned Elsters solely on the basis of Elsters' estimated net worth. It is undisputed, however, that they would not have advanced $4 million unless Frigitemp guaranteed that the money would be repaid. In short, then, the consideration for the $4 million loan was Elsters' promise of repayment plus a pledged asset and a guarantee of Elsters' allegedly solvent parent company.

This was a single transaction, a package deal, no part of which could have stood alone. To say, therefore, that there was no connection between the fraudulent misstatement of solvency and the "sale" of the asset and that "the Banks got exactly what they expected" is simply to blink reality. When a company sells something it owns, the purchaser does not get what he expects unless he receives the benefits of the warranties and guarantees that accompany the sale. *See, e.g., American Elec. Power Co. v. Westinghouse Elec. Corp.*, 418 F. Supp. 435, 442-43 (S.D.N.Y. 1976).

Long before the enactment of section 10(b), purchasers of stock were permitted to sue for damages or rescission because of fraud committed against them in connection with their purchase. *See, e.g., Woods-Faulkner & Co. v. Michelson*, 63 F.2d 569 (8th Cir. 1933) (defendant falsely represented that, if plaintiff would buy 500 shares of stock from defendant at $12.50 a share, defendant would repurchase the shares at the same price); *Issenhuth v. Kirkpatrick*, 258 F. 293 (8th Cir. 1919) (defendant sold plaintiff 250 shares of stock after misrepresenting the financial

status of the company, the amount of defendant's own investment, and that plaintiff's investment would bring him a district managership in the company). Because cases such as the foregoing did not provide adequate protection for purchasers of securities, Congress enacted the Securities Act to "[protect] the integrity of the marketplace in which securities are traded", *United States v. Brown*, 555 F.2d 336, 339 (2d Cir. 1977), and to "achieve a high standard of business ethics . . . *in every facet of the securities industry.*" *United States v. Naftalin*, 441 U.S. 768, 775 (1979) (quoting with emphasis added *SEC v. Capital Gains Bureau*, 375 U.S. 180, 186-87 (1963)).

To accomplish this salutary purpose, we consistently have read section 10(b) "flexibly, not technically and restrictively", *Drachman v. Harvey*, 453 F.2d 722, 737 n.3 (2d Cir. 1972) (en banc), and have construed broadly the phrase "in connection with", *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 861 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See United States v. Newman*, 664 F.2d 12, 18-19 (2d Cir. 1981), *judgment following remand affirmed by unreported order*, No. 82-1273 (Feb. 8, 1983), *cert. denied*, 52 U.S.L.W. 3240 (Oct. 3, 1983). Moreover, we have held squarely that "a 10b-5 action will survive even though the fraudulent scheme or device is unrelated to 'investment value.'" *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967).

In *A.T. Brod*, the defendant was alleged to have placed orders for the purchase of stock with the fraudulent intent of paying for the stock only if its market price went up. In the instant case, the pledge (sale) of the stock was accompanied by a guarantee of redemption (repurchase), made largely meaningless because of false and fraudulent

financial statements. *A.T. Brod* dealt with a promise to pay; the instant case deals with a promise to redeem. In both, there was misrepresentation with regard to the "sold" securities.

In *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 430 F.2d 355 (2d Cir. 1970), the panel majority reverted to the "fair market price" test, finding a "structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received." *Id.* at 360. Judge Hays, dissenting, cited numerous cases in support of his contention that this Court gave, and should continue to give, Rule 10b-5 a "broad and liberal interpretation." *Id.* at 362. In reversing, the Supreme Court cited *A.T. Brod & Co. v. Perlow, supra*, 375 F.2d at 393, and noted with apparent approval this Court's rejection in that case of the defendants' pleas that "no fraud is alleged as to the investment value of the securities nor any fraud 'usually associated with the sale or purchase of securities.'" 404 U.S. 6, 11 n.7 (1971).

The Supreme Court also cited *Allico Nat'l. Corp. v. Amalgamated Meat Cutters*, 397 F.2d 727 (7th Cir. 1968), in which the defendant breached a contract to sell plaintiff stock in a wholly owned insurance company and misappropriated other shares of stock being held in escrow for plaintiff, and *Cooper v. North Jersey Trust Co.*, 226 F. Supp. 972 (S.D.N.Y. 1964), which also involved the misappropriation of pledged securities.

In *Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811 (2d Cir. 1975), we followed the teachings of both *A.T. Brod* and *Bankers Life*. In that case, the defendant accounting firm was alleged to

have misrepresented the financial position of an investment fund, with the result that plaintiff retained the manager of the fund to manage plaintiff's own portfolio and suffered a resulting loss. Relying on the "touch" test of *Bankers Life, supra*, 404 U.S. at 12-13, we rejected the defendant's claim that its audit was not in connection with the purchase or sale of a security. 516 F.2d at 815.

In *Rubin v. United States*, 449 U.S. 424 (1981), Chief Justice Burger, writing for himself and seven other members of the Court, said, "Obtaining a loan secured by a pledge of shares of stock unmistakably involves 'disposition of [an] interest in a security for value.' " *Id.* at 429 (quoting § 2(3) of the Securities Act, 15 U.S.C. § 77(b)). Where, as here, fraudulent misrepresentations have led to the making of the loan, the fraud surely must have occurred in connection with the disposition of an interest in a security for value, *i.e.*, a 10(b) "sale".

With all due respect to my learned colleagues, I find little analogy to the present case in the situation posited by the majority in which a person pledges shares of General Motors stock as security for a $100,000 bank loan. In the first place, General Motors stock is nationally traded and has an established market value. In the second place, unlike Frigitemp, the would-be borrower of $100,000 does not control the corporation whose stock he is pledging and to whom the loan is being made. The relationship between parent and subsidiary corporations has been a matter of continuing concern to the Supreme Court. *See, e.g., Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510, 522-24 (1941); *Taylor v. Standard Gas & Elec. Co.*, 306 U.S. 307, 322 (1939); *Chicago, Milwaukee & St. Paul Ry. v. Minneapolis Civic & Commerce Ass'n*, 247 U.S. 490, 501

(1918). An in-depth review of the many decisions in this area is not needed to establish that the obligations which Frigitemp owed to "the entire community of interests" in Elsters, *see Superintendent of Ins. v. Bankers Life & Casualty Co., supra,* 404 U.S. at 12 (quoting *Pepper v. Litton,* 308 U.S. 295, 307 (1939)), are not fairly comparable to those which the holder of a few shares of General Motors owes to that company's "community of interests."

I am satisfied that Frigitemp's fraudulent guarantee of the Elsters loan and its pledge of the Elsters stock were integral parts of a "single seamless web", *id.,* in which appellee banks were ensnared and that a clear 10(b) connection existed between them. This being so, there is no need to decide at this point whether the lending negotiations between Frigitemp and the Banks were so integrated that the 10(b) connection carried over to the Frigitemp loans as well as that of Elsters. Because there was only one fraudulent scheme, so long as the district court has acquired jurisdiction of a portion of it that clearly is securities related, there is no reason why the Court should not be permitted to dispose of the entire action. *See Errion v. Connell,* 236 F.2d 447, 454 (9th Cir. 1956).[2]

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2. I cannot illustrate better the differences which separate the majority and the dissent than by quoting the sentence which concludes footnote 24 of Judge Friendly's opinion:

> Here the pledge of the Elsters stock, as to which no fraud is alleged, was merely an incident in a transaction not otherwise involving the purchase or sale of securities.

In holding that there was no fraud in connection with the pledge of the Elsters stock, the majority, of necessity, must disassociate the bailment of the stock from the underlying indebtedness which is secures. This, I suggest, misconstrues the basic elements of a pledge. A pledge is made up of "a bailment, a duty, and an agreement that the bailment is to secure the performance of a duty." Restatement of Security § 1

(footnote continued on next page)

comment g. "No pledge exists in the absence of a duty which the pledge secures, except where the pledgee relieves the pledgor from personal liability beyond the amount which can be realized from the pledged chattel." *Id. See Wm. H. Wise & Co. v. Rand McNally & Co.*, 195 F. Supp. 621, 627 (S.D.N.Y. 1961). In short, the pledge and the debt secured by it are inseparable. *In re R & L Engineering Co.*, 182 F. Supp. 317, 320 (S.D. Cal. 1960); Restatement of Security § 29 comment e. I cannot agree, therefore, that, where, as here, fraud is alleged in connection with the guaranteed performance of the secured duty, this Court can hold as a matter of law that there is no connection between the fraud and the pledge.

I likewise cannot agree that, on the papers before us, we can hold that the pledge of the Elsters stock was a mere "incident" to the $4 million Elsters loan. If, as the majority correctly holds, a pledge is a "sale" for purposes of section 10(b), there is nothing about the pledge in the instant case that makes it more "incidental" than any other pledge.

In summary, we are dealing with a $4 million loan to a company so far financially removed from General Motors that its entire issue of common stock was required to be pledged as security. It was obvious to the lending banks that, if, as actually happened, Elsters could not repay the loan, the pledged stock would be greatly depreciated in value. For that reason, the Banks sought and got a guarantee from Frigitemp that the secured obligation would be paid.

Assuming that the majority correctly reads an "incidental" connection exception into section 10(b), this is not a case for the application of that exception. Both the obligation and the guarantee of its performance were directly and intimately connected to the pledge.

APPENDIX C

Opinion of the United States District Court for the Southern District of New York, dated December 21, 1982 (552 F. Supp. 439)

CHEMICAL BANK,

Plaintiff,

v.

ARTHUR ANDERSEN & Co., Gerald Lee, Mervyn Silver, Joseph Heilbrun, and John Does, Numbered One through Twenty, the latter being fictitious names,

Defendants.

MANUFACTURERS HANOVER TRUST COMPANY and First Pennsylvania Bank, N.A.,

Plaintiffs,

v.

ARTHUR ANDERSEN & Co., Gerald Lee, Mervyn Silver and Joseph Heilbrun,

Defendants.

SECURITY PACIFIC NATIONAL BANK,

Plaintiff,

v.

ARTHUR ANDERSEN & Co., Gerald Lee, Mervyn Silver and Joseph Heilbrun,

Defendants.

Nos. 79 Civ. 2474 (GLG), 79 Civ. 2533 (GLG) and 79 Civ. 2928 (GLG).

United States District Court, S.D. New York

Dec. 21, 1982

OPINION

GOETTEL, District Judge:

This is an action[1] for violations of section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934 (1934 Act), section 17(a) of the Securities Act of 1933 (1933 Act), and state common law. Before this Court is defendant Arthur Andersen & Co.'s (Andersen) motion to dismiss and for summary judgment.

The plaintiffs in this action are four commercial banks, Manufacturers Hanover Trust Company (MHT), First Pennsylvania Bank, N.A. (First Pennsylvania), Chemical Bank (Chemical), and Security Pacific National Bank (Security Pacific). (They will be referred to collectively as the Banks.)[2] The principal defendant[3] is Andersen, a public

1. Put precisely, there are three actions: *Chemical Bank v. Arthur Andersen & Co.*, No. 79 Civ. 2474; *Manufacturers Hanover Trust Co. and First Pennsylvania Bank, N.A. v. Arthur Andersen & Co.*, No. 79 Civ. 2533; and *Security Pacific National Bank v. Arthur Andersen & Co.*, No. 79 Civ. 2978. Because the complaints are virtually identical, *see infra* note 9, this Court will write as if there is one complaint and one action. When there are important distinctions among the actions, they will be noted.

2. MHT is a New York corporation with its principal place of business in New York. First Pennsylvania is a National Banking Act corporation with its principal place of business in Philadelphia. Chemical is a New York corporation with its principal place of business in New York. Security is a National Banking Act corporation with its principal place of business in Los Angeles.

3. The other named defendants are Gerald Lee, Mervyn Silver, and Joseph Heilbrun. At all times relevant to this lawsuit, Gerald Lee was the Chairman of the Board, Chief Executive Officer, and a director of the Frigitemp Corporation, Mervyn Silver was the President, Executive Vice President, Chief Operating Officer, and a director of the Frigitemp Corporation, and Joseph Heilbrun was the Senior Vice President, Treasurer, and a director of the Frigitemp Corporation. Moreover, an additional 21 John Doe defendants are mentioned in the Chemical complaint.

accounting firm with offices throughout the United States and the world. From 1973 until 1979, Andersen was the independent public accountant for the Frigitemp Corporation (Frigitemp), a New York corporation that is now in bankruptcy.[4]

This lawsuit arises from a series of loans made by the Banks to Frigitemp and one of its wholly owned subsidiaries, Elsters, Inc. (Elsters). During the mid-1970's, Frigitemp, which had earlier embarked upon a course of rapid expansion, required large amounts of capital, and it looked to the Banks for financing. The Banks obliged.

The money was advanced and the obligations of the parties defined in three transactions. The first will be called the Secured Credit Transaction. In a contract dated December 31, 1975 (the Secured Credit Agreement), the Banks agreed to provide Frigitemp with a line of credit up to $8 million. Beginning in 1976, the Banks advanced approximately $6.5 million to Frigitemp. These advances were secured by a pledge of Frigitemp's customer notes receivable and were evidenced by Frigitemp's promissory notes.

The second transaction will be called the Unsecured Loan Transaction. In September 1976, the Banks and Frigitemp began discussing the need to restructure Frigitemp's debt. Pending formal restructuring, which was expected to occur in 1977, Frigitemp asked for and received a $5 million short term loan from MHT, Chemical, and Security Pacific. The funding took place in two stages. In September 1976, the Banks advanced $1.5 million to Frigi-

4. On March 20, 1978, Frigitemp petitioned for an arrangement pursuant to Chapter XI of the Bankruptcy Act in the Bankruptcy Court of the United States District Court for the Southern District of New York. According to the Banks, the pendency of the bankruptcy proceeding is the only reason that Frigitemp was not named as a defendant in this action.

temp, and Frigitemp gave a one month promissory note to each bank. In October 1976, the three banks advanced $3.5 million to Frigitemp, and Frigitemp gave each bank a three month promissory note that reflected the September 1976 financing and that matured on February 28, 1977. (The maturity of these notes was later extended to April 30, 1977.) In February 1977, Frigitemp received an additional $4 million unsecured loan from all four banks and gave each bank a promissory note that matured on April 30, 1977.

The final transaction occurred in August 1977. From March 1977 until August 1977, Frigitemp's management and members of the Banks' senior management discussed Frigitemp's future financial needs and the terms and conditions of the debt restructuring. The fruit of these negotiations was the August 1977 transaction, in which the Banks restructured Frigitemp's debt and provided $4 million in new financing to Elsters.

There were essentially three parts to this transaction, although the Banks maintain that "[a]ll three agreements (plus the Pledge and Guarantee) were structured as, and were intended to be, part of one single, integrated refinancing package." O'Neill Affidavit ¶ 26. First, the Banks extended the maturity date on the unsecured notes from April 30, 1977 to March 31, 1978. To reflect this change, Frigitemp executed new notes in substitution for the prior indebtedness. (These will be called the Replacement Notes.) Second, the Banks extended the maturity date on the notes issued pursuant to the Secured Credit Agreement from July 1, 1977 to July 1, 1978. *See id.* ¶ 28. To reflect this change, the notes were amended by endorsements dated August 9, 1977. (These will be called the Note Endorsements.) Finally, the Banks advanced $4 million to Elsters. Elsters gave the Banks promissory notes that matured on

March 31, 1978; Frigitemp guaranteed the loan and pledged 100% of Elsters common stock, 750 shares, pursuant to a Pledge and Security Agreement.

Thus, as of August 1977, Frigitemp and Elsters owed the Banks approximately $19.5 million. By the time that Frigitemp filed its bankruptcy petition in 1978, however, only approximately one-third of that amount had been repaid.[5]

The Banks commenced this action in 1979 in what is essentially an attempt to hold Andersen liable for these losses. They allege that they entered into the transactions with Frigitemp and Elsters in reliance on Frigitemp's financial statements audited and certified by Andersen for the years 1973-1976 and that these statements were materially false and misleading.[6] According to the Banks,

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5. The Banks did, however, assign four notes to third parties for approximately $407,345 each.

6. The Banks allege that the statements were false and misleading in the following respects:

a) the profit reported from long-term contracts was materially overstated because the costs to Frigitemp of fulfilling those contracts were consistently understated;

b) Frigitemp's report of its income and its current assets included sums representing amounts claimed as owed to Frigitemp for material costs and work done as additions to or changes from specifications under certain long-term contracts. Such amounts were materially overstated and included amounts for work not actually performed and for work which was not then billed to or approved by Frigitemp's customers; and

c) Frigitemp's accounts receivable were overstated in the following respects, among others:

(i) Frigitemp was overbilling its customers;

(ii) Frigitemp reported unbilled amounts which in material respects were not billable as receivables;

(iii) Frigitemp allocated payments received on current receivables to older receivables, thereby understating the amount of aged receivables of doubtful collectibility;

(iv) the disputed claim reported in the 1976 Statements as a receivable in the sum of $8.9 million was spurious and improperly

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Andersen's conduct in preparing and certifying these statements amounted to violations of the securities laws: the first claim is that Andersen violated section 17(a) of the 1933 Act and section 10(b) and rule 10b-5 of the 1934 Act; the fourth claim is that Andersen aided and abetted violations of these provisions.[7]

Andersen filed this motion in 1982, after extensive discovery. It contends that this Court lacks jurisdiction because the alleged fraud was not "in connection with" the purchase or sale of a security and that the complaint fails to state a claim against Andersen as either a primary violator of the securities laws or as an aider and abettor.[8]

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documented and should not have been reported as a receivable; and

(v) other claims for which work had not been performed by Frigitemp were reported as receivables.

MHT Complaint ¶ 21. The same allegations are contained in paragraph 20 of the *Security Pacific* Complaint and paragraph 22 of the *Chemical* Complaint.

It should also be noted that alleged misrepresentations in Frigitemp's financial statements have spawned two other actions that are pending before this Court, *Aeronca, Inc. v. Gorin*, No. 80 Civ. 1509, and *Peerless Insurance Co. v. Arthur Andersen & Co.*, No. 80 Civ. 2556, as well as a settled class action involving a public offering. *Litowitz v. Arthur Andersen & Co.*, No. 78 Civ. 3100.

7. The second and third claims are for violations of state law. They are not germane to this motion.

8. Andersen also makes two other arguments in support of its motion. First, it argues that the Banks were members of the class in a class action captioned *Litowitz v. Arthur Andersen & Co.*, No. 78 Civ. 3100 (S.D.N.Y. Nov. 25, 1981), and that, because of the settlement and judgment in that action, the Banks' claims are barred by *res judicata*. Even if it is assumed that the Banks were class members, the Court disagrees. The settlement and judgment in the *Litowitz* action, which was based on the purchase of Frigitemp common stock and debentures, cannot be held to bar the claims based on notes issued by Frigitemp and on loans guaranteed by Frigitemp and secured by a pledge of Elsters stock. *See National Super Spuds, Inc. v. New York Mercantile Exchange*, 660 F.2d 9, 17-19 (2d Cir. 1981). Second,

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For the reasons stated below, Andersen's motion is denied.[9]

I. *Jurisdiction Under the Securities Laws*

The *sine qua non* of a federal court's jurisdiction to hear a claim under section 10(b) of the 1934 Act is a misrepre-

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Andersen argues that, as a matter of policy, this Court should not recognize a private cause of action under § 10(b) of the 1934 Act and § 17(a) of the 1933 Act "to recover a loss on an unpaid loan, whether or not represented by a note or secured by stock." Memorandum of Law of Defendant Arthur Andersen & Co. in Support of Motion to Dismiss and for Summary Judgment at 32. Although this Court has considered these policy arguments in determining whether the notes in question are securities, it will not use them to deny a cause of action to the Banks even though the Banks have stated a claim under § 10(b) and § 17(a). To this Court's knowledge, there have been no cases in which a cause of action under the securities laws has been denied solely because the allegedly defrauded party was a bank.

9. Before proceeding to the discussion of the legal issues, two things should be mentioned. On this motion, the Court has accepted as true all facts pleaded in the complaint and has drawn all inferences of fact in favor of the Banks, the parties opposing the motion. In essence, the Court has examined the pleadings, affidavits, and documents and has determined whether the Banks' version of the facts is sufficient to state a claim under § 10(b) and § 17(a). To the extent that Andersen argues that the Banks cannot prove their claims, the argument is rejected at this time; the Banks have met their burden of showing the existence of genuine issues of material fact. *See* Fed.R. Civ.P. 56.

Second, the Banks have also moved for leave to amend their complaints to reflect transactions in which the Banks made personal loans to certain officers of Frigitemp and accepted pledges of Frigitemp common stock as security for the loans. Additionally, Chemical has moved for leave to amend its complaint further to conform with the complaints in the other two actions. Insofar as Chemical seeks to conform its complaint, the motion is granted. As to the remainder of the motion, the Court expresses no opinion at this time. It should be noted, however, that, if the Court had concluded that it had no subject matter jurisdiction over the claims arising from the loans to Frigitemp and Elsters, and if it had permitted the Banks to amend, the Court would not have used the claims arising from the loans to the Frigitemp officers as a basis for exercising pendent jurisdiction over the other claims. *See generally* 13 C. Wright, A. Miller & E. Cooper, Federal Practice and Procedure § 3567 (1975).

sentation "in connection with the purchase or sale of [a security]," 1934 Act § 10(b), 15 U.S.C. § 78j(b)(1976); under section 17(a) of the 1933 Act, it is a misrepresentation "in the offer or sale of [a security]," 1933 Act § 17(a), 15 U.S.C. § 77q(a)(1976). The Banks assert that these requirements are satisfied by virtue of the notes issued in connection with the August 1977 transaction and the pledge of Elsters stock. Andersen, on the other hand, argues that the notes are not securities[10] and that the alleged fraud was not "in connection with" the pledge of Elsters stock.

A. *The Notes As Securities*

Three types of notes were issued in connection with the August 1977 transaction. First, there were the Replacement Notes issued by Frigitemp to the Banks in substitution for the prior unsecured indebtedness. These notes were issued on August 9, 1977 and matured on March 31, 1978, a period of approximately eight months. They provided for a definite rate of interest tied to the prime rate of the lending bank, and they were unsecured. Second, there were the Note Endorsements that amended the notes issued pursuant to the Secured Credit Agreement. The endorsements were dated August 9, 1977 and extended the maturity date on the notes to July 1, 1978. The notes, as amended, provided for a definite rate of interest tied to the prime rate of the lending bank, and they were secured

10. In its reply papers, Andersen also argues that the issuance of the Replacement Notes and the Note Endorsements cannot qualify as purchases of new securities because they merely reflect loans that had previously been made. The Court, however, believes that acceptance of these notes by the Banks constituted a new investment decision and, consequently, purchases within the meaning of the securities laws. *See Fischer v. New York Stock Exchange*, 408 F.Supp. 745, 755 (S.D.N.Y. 1976).

by Frigitemp's customer notes receivable. Third, there were the notes issued by Elsters to reflect the $4 million advance. These notes were issued on August 9, 1977 and matured on March 31, 1978, a period of approximately eight months. They provided for a definite rate of interest tied to the prime rate of the lending bank, and they were secured by Frigitemp's pledge of Elsters common stock. Moreover, the underlying loan agreement provided that the proceeds of the loan were to be added to Elsters' working capital for use in the ordinary course of business.

Whether these notes are securities is not an easy question. The 1933 Act provides that, unless the context otherwise requires, "[t]he term 'security' means any note." 1933 Act § 2(1), 15 U.S.C. § 77b(1) (1976). Although "[a]ny note ... which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited," is exempt from the 1933 Act's registration requirements, 1933 Act § 3(a)(3), 15 U.S.C. § 77c(a)(3) (1976), it is clear that this exemption does not apply to the Act's antifraud provisions. *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1131 (2d Cir.1976) (quoting *Zeller v. Bogue Electric Manufacturing Corp.*, 476 F.2d 795, 799 (2d Cir.), *cert. denied*, 414 U.S. 908, 94 S.Ct. 217, 38 L.Ed.2d 146 (1973)); Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 Bus.Law. 1567, 1572, 1574-75 (1980); *see* 1933 Act § 12(2), 15 U.S.C. § 77*l*(2) (1976); *id.* § 17(c), 15 U.S.C. § 77q(c) (1976). The 1934 Act provides that unless the context otherwise requires, "[t]he term security means any

note . . . but shall not include any note . . . which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." 1934 Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1976). Thus, a literal reading of the statutes would mean that all notes are securities for purposes of section 17(a) of the 1933 Act and all notes with a maturity of greater than nine months are securities for the purposes of section 10(b) of the 1934 Act.

Despite the broad statutory language, however, not every note is a security. *Oliver v. Bostetter,* 426 F.Supp. 1082, 1085 (D.Md.1977); *see Exchange National Bank v. Touche Ross & Co., supra,* 544 F.2d at 1133-37; *Zeller v. Bogue Electric Manufacturing Corp., supra,* 476 F.2d at 800. Perceiving that Congress, in passing the securities laws, intended to protect investors, *see Tcherepnin v. Knight,* 389 U.S. 332, 336, 88 S.Ct. 548, 553, 19 L.Ed.2d 564 (1967), and not "to regulate commercial loan transactions that would have no impact on the securities markets," *American Fletcher Mortgage Co. v. U.S. Steel Credit Corp.,* 635 F.2d 1247, 1254 (7th Cir.1980), *cert. denied,* 451 U.S. 911, 101 S.Ct. 1982, 68 L.Ed.2d 300 (1981), most courts have held that, regardless of maturity, a note is a security only if it evidences an investment transaction; if it merely reflects a commercial loan transaction, the provisions of the securities laws do not apply. *Id.* at 1254; *National Bank of Commerce v. All American Assurance Co.,* 583 F.2d 1295, 1301 (5th Cir.1978); *Great Western Bank & Trust v. Kotz,* 532 F.2d 1252, 1256 (9th Cir.1976); *C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.,* 508 F.2d 1354, 1359 (7th Cir.), *cert. denied,* 423 U.S. 825, 96 S.Ct. 38, 46 L.Ed.2d 40 (1975); *McClure v. First National Bank,* 497 F.2d 490, 493-95 (5th

Cir.1974), *cert. denied,* 420 U.S. 930, 95 S.Ct. 1132, 43 L.Ed.2d 402 (1975); *Briggs v. Sterner,* 529 F.Supp. 1155, 1167 (S.D.Iowa 1981); *Robbins v. First American Bank,* 514 F.Supp. 1183, 1187-88 (N.D.Ill.1981); *see Exchange National Bank v. Touche Ross & Co., supra,* 544 F.2d at 1134-37; Sonnenschein, *supra,* at 1587-89. This is known as the commercial-investment dichotomy. *See National Bank of Commerce v. All American Assurance Co., supra,* 583 F.2d at 1301; *Great Western Bank & Trust v. Kotz, supra,* 532 F.2d at 1256; Sonnenschein, *supra,* at 1588.

Courts utilizing the commercial-investment dichotomy judge a particular note transaction "against the attributes of an 'investment' and [accord antifraud coverage only to those transactions that sufficiently] display those attributes." Sonnenschein, *supra,* at 1588. The Ninth Circuit, for example, has noted that factors such as the term of the note,[11] the nature and extent of collateralization,[12] the form of the obligation,[13] the circumstances of issuance,[14] the relationship between the amount borrowed and the size of the

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11. [T]he longer one's funds are to be used by another, the greater the risk of loss.

A demand or short-term note is almost *ipso facto* not a security unless payment is dependent upon the success of a risky enterprise, or the parties contemplate indefinite extension of the note or perhaps conversion to stock.

532 F.2d at 1257-58.

12. "The unsecured lender is generally more dependent upon the managerial skills of the borrower than is a secured party who can look to the collateral in case of inability to repay." 532 F.2d at 1258 (footnote omitted).

13. While not controlling, the form utilized may help to explain the circumstances of issuance of the obligation." 532 F.2d at 1258.

14. "Whether the obligations were issued to a single party or to a large class of investors sheds light on the nature of the financing." 532 F.2d at 1258.

borrower's business,[15] and the contemplated use of the proceeds[16] can be useful in determining whether a given note transaction represents an investment. *Great Western Bank & Trust v. Kotz, supra,* 532 F.2d at 1257-58.[17] If these

15. "[T]he larger the relative amount, the greater the stake, and therefore the risk, of the lender." 532 F.2d at 1258.

16. "Proceeds constituting an essential ingredient of enterprise formation . . . are generally securities. On the other hand, those used to maintain current financial position generally are not." 532 F.2d at 1258.

17. Other circuits have also suggested criteria for distinguishing commercial notes from investment securities. The Seventh Circuit, for example, found the following criteria helpful:

> (1) how is the instrument characterized in the business community? (2) how are the proceeds to be used (if for consumer goods or particular business goods or services—not covered, but if for general financing of borrower's enterprise—covered)? (3) extent of reliance on efforts of others (placing funds at great risk, giving note payee extensive collateral rights, making repayment of funds contingent upon some event, all tend to indicate security rather than loan); (4) number of notes issued, number of payees, dollar amount of transaction; (5) payable on demand or if payable at fixed time, how long is the time between issuance and maturity? and (6) characterization of notes on relevant financial statements.

C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, 508 F.2d at 1361. The Fifth Circuit has noted that when "notes have been deemed securities within the meaning of the securities laws, either of two factors . . . usually indicated the investment overtones of the underlying transactions," *McClure v. First National Bank, supra,* 497 F.2d at 493 (footnote omitted): first, the notes were offered to a class of investors and acquired for speculation or investment, *id.;* second, the borrower "obtain[ed] investment assets, directly or indirectly, in exchange for its notes," *id.* at 494.

Despite the attempts to articulate the general characteristics of an investment transaction, however, most courts recognize that no mechanical formula can be used to establish a precise line of demarcation between investment and commercial transactions. *Great Western Bank & Trust v. Kotz, supra,* 532 F.2d at 1258; *C.N.S. Enterprises, Inc. v. G .& G. Enterprises, Inc., supra,* 508 F.2d at 1359, 1362 & n. 14; *Robbins v. First American Bank, supra,* 514 F.Supp. at 1187-88; *see* Sonnenschein, *supra,* at 1589. As the Seventh Circuit noted,

(footnote continued on next page)

factors were applied to the present case, a result that the notes did not represent an investment worthy of protection under the securities laws would certainly seem defensible. First, the notes were for a short term: the Replacement Notes and the Elsters notes had a maturity of less than nine months, the Note Endorsements had a maturity of eleven months. Second, the Note Endorsements and the Elsters notes were fully secured: the Note Endorsements by Frigitemp's customer notes receivable, the Elsters notes by 100% of Elsters common stock. Third, the notes were for a fixed amount, had a fixed maturity, and had a stated rate of interest. Thus, repayment did not depend solely upon the profit or productivity of Frigitemp and Elsters. *See National Bank of Commerce v. All American Assurance Co., supra,* 583 F.2d at 1301. Finally, a large class of investors was not involved. The obligations evidenced by the notes and the underlying agreements resulted from months of negotiations between the parties and were tailored to meet the needs of both Frigitemp and the Banks. In sum, the notes had the essential characteristics of an instrument

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> [i]n one sense every lender of money is an investor since he places his money at risk in anticipation of a profit in the form of interest. Also in a broad sense every investor lends his money to a borrower who uses it for a price and is expected to return it one day.
>
> On the other hand, the polarized extremes are conceptually identifiable: buying shares of the common stock of a publicly-held corporation, where the impetus for the transaction comes from the person with the money, is an investment; borrowing money from a bank to finance the purchase of an automobile, where the impetus for the transaction comes from the person who needs the money, is a loan. In between is a gray area which, in the absence of further congressional indication of intent or Supreme Court construction, has been and must be in the future subjected to case-by-case treatment.

C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., supra, 508 F.2d at 1359.

representing a commercial loan. *See generally Great Western Bank & Trust v. Kotz, supra,* 532 F.2d at 1260 ("A note given to a bank in the course of a commercial financing transaction is not generally a security within the meaning of the federal securities [laws]."); Sonnenschein, *supra,* at 1581 ("in most cases in which institutional lenders have made federal antifraud claims, [coverage has been] denied").

Application of the commercial-investment dichotomy, however, is inappropriate in the Second Circuit. Rather, determination of whether a note is a security is governed by the test enunciated by Judge Friendly in *Exchange National Bank v. Touche Ross & Co., supra. See Banco Nacional de Costa Rica v. Bremar Holdings Corp.,* 492 F.Supp. 364, 368 (S.D.N.Y.1980); *SEC v. Garfinkle,* [1978] Fed.Sec.L.Rep. (CCH) ¶ 96,465, at 93,700 (S.D.N.Y.1978); *Altman v. Knight,* 431 F.Supp. 309, 311-12 (S.D.N.Y.1977). In that case, Judge Friendly, after reviewing the decisions that applied the commercial-investment dichotomy, concluded that "the efforts to provide meaningful criteria for decision under 'the commercial-investment' dichotomy do not seem to us to carry much promise of success." *Id.* at 1136.[18] He

18. Judge Friendly also noted the concurring opinion in *Great Western Bank & Trust v. Kotz, supra,* in which Judge Wright apparently suggested that the securities laws should not apply when a bank receives a note in the exercise of its lending functions. 544 F.2d at 1136-37. Although finding this approach "rather appealing," *id.* at 1136, Judge Friendly rejected it. He noted that

> [o]ne reason [for rejecting Judge Wright's suggestion] is that, in framing his exception, under the influence of the facts in the case in hand which are also present here, he seems to look at the matter solely, or at least principally, from the standpoint of a bank seeking to invoke the federal securities laws as a remedy supplementing those afforded by state laws. However, as shown by several of the cases cited, often it is the borrower who asserts

(footnote continued on next page)

therefore adopted what has been termed a literalist or neo-literalist approach to the subject of notes as securities. *Union Planters National Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1180 n. 7 (6th Cir.), *cert. denied*, 454 U.S. 1124, 102 S.Ct. 972, 71 L.Ed.2d 111 (1981); Sonnenschein, *supra*, at 1602; *see Exchange National Bank v. Touche Ross & Co., supra*, 544 F.2d at 1137 ("the best alternative now available may lie in greater recourse to the statutory language"). In Judge Friendly's words,

> [a] party asserting that a note of more than nine months maturity is not within the 1934 Act (or that a note with a maturity of nine months or less is within it) or that any note is not within the anti-fraud provisions of the 1933 Act has the burden of showing that "the context otherwise *requires.*" (Emphasis supplied.) One can readily think of many cases where it does—the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a

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fraud by the lender. Judge Wright's arguments based on a bank's superior bargaining position and its special investigatory facilities would have little bearing in such a case; indeed the former would weigh in favor of holding the note to be a security. Yet we see nothing in the statutes that would justify holding that the same note was a security when a borrower from a bank invoked federal law and not a security when the bank asserted this. Even when it is the bank that invoked the federal securities laws, we would find it hard to reconcile with the statutory language a holding that where a bank or a group of banks loaned many millions of dollars to a corporation for periods of several years, the antifraud provisions of the federal securities laws do not apply. While banks are in a favored position to obtain disclosure, the target of §§ 10(b) of the 1934 Act and 17(a) of the 1933 Act is fraud, which a bank's ability to obtain disclosure cannot always prevent.

Id. at 1137 (footnote omitted).

> bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized). When a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, [section] 10(b) of the 1934 Act should generally be held to apply.

Id. at 1137-38 (footnotes omitted).[19]

Applying Judge Friendly's test to this case, the Court finds that the Note Endorsements are not securities. These notes, which were for a short term and which were secured by Frigitemp's customer notes receivable, bear a strong family resemblance to "short-term notes secured by an assignment of accounts receivable." *Id.* at 1138. The Replacement Notes, on the other hand, bear no resemblance to the examples delineated by Judge Friendly and would presumptively be securities for purposes of section 17(a) of

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19. Andersen argues that this is not the test enunciated by Judge Friendly. It contends that *Exchange National Bank* requires a court to determine whether a note is a security by examining the following criteria: whether the loan transaction was negotiated by the lenders' administrative officers or by lending officials; whether the form of the note was dictated by the lender or the borrower; whether the notes resembled standard forms used in commercial lending; whether the maturity date was fixed or depended on long-term advance notice by the lender; whether the loan was subordinated; whether the notes were transferable and prepayment allowed; whether the loan was secured by after-acquired collateral and set-off rights; and whether the loan was part of a borrower's complex financing operation involving multiple subordinated creditors. *See* Reply Memorandum of Law of Defendant Arthur Andersen & Co. in Support of Motion to Dismiss and for Summary Judgment at 48-56. This is incorrect. In *Exchange National Bank*, Judge Friendly utilized the above factors only to show that the result reached in the case would have been the same had the commercial-investment dichotomy been used. 544 F.2d at 1138 ("If ours is the correct approach, affirmance is clearly demanded—as it doubtless also would be by the 'commercial-investment' dichotomy.")

the 1933 Act.[20] Their status under the 1934 Act, however, is not as clear because the notes had a maturity at the time of issuance of less than nine months.

Judge Friendly offered no guidance for determining "the status under the 1934 Act of a note with a maturity of nine months or less that does not bear such a strong family resemblance." *Id.* at 1138 n. 19; *see also Franklin Savings Bank v. Levy,* 551 F.2d 521, 528 n. 11 (2d Cir.1977). Nevertheless, under the circumstances of this case, the Court concludes that the Replacement Notes are securities. Because the notes do not bear a strong family resemblance to the examples delineated by Judge Friendly, they would presumptively be securities for purposes of section 17(a). The Court can perceive no reason for differentiating between section 17(a) and section 10(b) and holding that the notes are securities under one provision, but not the other.[21] *See*

20. It can be argued that Judge Friendly did not intend the "strong family resemblance test" to apply to § 17(a) because he said that "[w]hen a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply." 544 F.2d at 1138 (footnote omitted). When the passage is read in context, however, it appears that such a narrow reading is inappropriate.

21. Although the text of *Exchange National Bank* requires the Court to presume that a note is a security under § 17(a) unless the note bears a strong family resemblance to the examples delineated in the opinion, it can be argued that when Judge Friendly "[left] for another day . . . the question whether a note which because of its short term would not be a security under § 10(b) of the 1934 Act might be one within the antifraud provisions of the 1933 Act," 544 F.2d at 1138, he implied that the presumption is not appropriate when dealing with short-term notes, that is, notes with a maturity of nine months or less. If this argument were correct, a conclusion that the Replacement Notes are securities under § 10(b) because there is no reason for differentiating between § 17(a) and § 10(b) would clearly not be viable. The Court, however, need not determine Judge Friendly's intent, because the conclusion that the Replacement Notes are securities under § 10(b) is not based solely on this rationale; another reason is that the actual effect of the Replacement Notes was to extend the maturity date on the existing unsecured notes from April 30, 1977 until March 31, 1978, a period of eleven months. *See infra.*

Sonnenschein, *supra,* at 1575;[22] *see also Zeller v. Bogue Electric Manufacturing Corp.,* 476 F.2d at 799-800.[23] Moreover, although the Replacement Notes had a maturity of less than nine months when issued on August 9, 1977, their actual effect was to extend the maturity date on the existing unsecured notes from April 30, 1977 until March 31, 1978, a period of eleven months. *See* Note Replacement Agreement, Ross Affidavit Ex. 9, at 1 (the Replacement Notes were issued "to extend the maturity of the Existing Notes"). This makes the Court especially reluctant to conclude that these notes are excluded from the coverage of section 10(b) solely because of their short term.[24]

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22. Sonnenschein concludes that, because the 1933 Act's registration exemption for short-term notes does not apply to the Act's antifraud provisions, "a similar result with respect to the coverage of the antifraud provisions of the 1934 Act [is suggested]. This comports with the differing policies underlying the 1933 Act registration scheme, on the one hand, and the antifraud scheme of both Acts, on the other." Sonnenschein, *supra,* at 1575 (footnote omitted).

23. The Securities and Exchange Commission has taken the position that the registration exemption of the 1933 Act applies only to "prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks." Securities Act Release No. 4412, 26 Fed.Reg. 9158, 9159 (1961). In *Zeller v. Bogue Electric Mfg. Corp., supra,* Judge Friendly concluded that "[w]e have no doubt that the Commission would take the same view with respect to the [short term note exemption of the 1934 Act]," and that "the mere fact that a note has a maturity of less than nine months does not take the case out of [section 10(b)], unless the note fits the general notion of 'commercial paper' reflected in the SEC Release." *Id.* at 800. It is unclear how *Exchange National Bank* affects these conclusions. If it has had no effect and if the Replacement Notes do not fit the definition of commercial paper contained in the SEC Release (a question that has not been addressed on this motion), *Zeller* could provide another basis for holding that the notes are not excluded from the coverage of § 10(b) solely because of their short term.

24. Because of the conclusion that the Replacement Notes are securities, the Court does not address the status of the Elsters notes.

Andersen's fallback position is that *Exchange National Bank* is no longer controlling precedent because the Supreme Court, in *Marine Bank v. Weaver,* 455 U.S. 551, 102 S.Ct. 1220, 71 L.Ed.2d 409 (1982),[25] rejected the literalist approach in favor of one that emphasizes the economic realities of a given transaction. This interpretation has not been accepted in this Circuit. In *Golden v. Garafalo,* 678 F.2d 1139 (2d Cir.1982), a case decided after *Weaver,* the Second Circuit concluded that an economic reality analysis is inappropriate in most situations and essentially affirmed the literalist approach to determining whether an instrument is a security within the meaning of the securities laws.[26] It noted that

> [w]e believe that Congress intended to draft an expansive definition [of the term "security"] and to include with specificity all instruments with characteristics agreed upon in the commercial world, such as "debentures," "stock," "treasury stock" or "voting-trust certificates." Catch-all phrases such as "investment

25. In *Weaver,* the plaintiffs pledged a conventional certificate of deposit issued by the defendant, a commercial bank, to the defendant to guarantee a loan made by the defendant to another company. In return for their guarantee, the plaintiffs, pursuant to an agreement with the company's owners, were to receive 50% of the company's profits and $100 per month as long as they guaranteed the loan. They were also given use of the company's barn and pasture and the right to veto future borrowing by the company. 102 S.Ct. at 1222. The deal, however, went sour, and the plaintiffs sued under the antifraud provisions of the securities laws. The Supreme Court held that neither the certificate of deposit nor the agreement were securities. *Id.* at 1223, 1223-25.

26. In *Golden,* the Second Circuit rejected the "sale of business doctrine," which provides that "a sale of a business effectuated by a transfer of stock does not involve a 'security' within the meaning of the [securities laws] when the 'economic reality' of the transaction is 'commercial'—acquiring a business to manage—rather than 'investment'—receiving income from capital without managerial effort." 678 F.2d at 1141.

contract," were then included to cover unique instruments not easily classified. If the "economic reality" test were to be the core of the definition, only general catch-all terms would have been used.

* * *

Our prior cases fully support this view. In *Movielab, Inc. v. Berkey Photo, Inc.*, 452 F.2d 662 (2d Cir. 1971), we held that two 8% installment notes, in the amount of $5,250,000 each, given by Movielab to Berkey and payable over 20 years were "securities" because they were "notes." In "economic reality," the transaction was merely a sale of assets on credit and, therefore, of a commercial, rather than investment, nature. We have reaffirmed *Movielab* in a post-[*United Housing Foundation v.*] *Forman* [421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621] decision. *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1133 (2d Cir.1976). Judge Friendly's opinion in that case noted the "dubious value" of the *Howey* [*SEC v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244] "economic reality" test in the context of determining what kind of "notes" are "securities," *id.* at 1136, and suggested that even in the light of *Forman*, "the best alternative . . . may lie in greater recourse to the statutory language." *Id.* at 1137. We agree fully with Judge Friendly that however great the merits of the *Howey* test in determining what falls within the catch-all phrase "investment contract," it is of little help in determining the meaning of more specific words which refer to instruments with commonly agreed upon characteristics, such as "stock."

* * *

Congress thus may have had good reason to draft the definition of "security" so as to include all instruments having commonly agreed upon characteristics, such as "stock," leaving "economic reality" to

> govern only the catch-all phrase "investment contract" in cases involving unusual or unique instruments. The dangers in creating uncertainty as to the scope of the Acts and in generating slippery legal and factual issues going to jurisdiction are substantial. We regard that as having been the legislative judgment, and we give it force.

Id. at 1144-46.

The clear import of *Golden* is that *Exchange National Bank* is still the law in this Circuit. Thus, although there may well be merit to the commercial-investment dichotomy, the Court is bound to follow Judge Friendly's literalist approach and hold that the Replacement Notes are securities and that there is jurisdiction to hear the Banks' claims under the securities laws.

B. The Pledge of Elsters Stock

Whether the pledge of Elsters stock is sufficient to support the exercise of jurisdiction is also an interesting issue. To resolve it, two questions must be answered: first, whether the pledge of Elsters stock was a sale within the meaning of the securities laws; second, whether the alleged fraud occurred "in connection with" the pledge.

The answer to the first question is clear: a pledge of stock is equivalent to a sale for purposes of section 17(a) of the 1933 Act, *Rubin v. United States,* 449 U.S. 424, 431, 101 S.Ct. 698, 702, 66 L.Ed.2d 633 (1981); *United States v. Gentile,* 530 F.2d 461, 466-67 (2d Cir.), *cert. denied,* 426 U.S. 936, 96 S.Ct. 2651, 49 L.Ed.2d 388 (1976), and section 10(b) of the 1934 Act, *Mallis v. Federal Deposit Insurance Corp.,* 568 F.2d 824, 828-30 (2d Cir.1977), *cert. dismissed,* 435 U.S. 381, 98 S.Ct. 1117, 55 L.Ed.2d 357 (1978); *see Marine Bank v. Weaver, supra,* 102 S.Ct. at 1222 n. 2 (Su-

preme Court implied that its holding in *Rubin* was applicable to section 10(b)).[27] The question that has been debated by the parties is whether the alleged fraud occurred "in connection with" the pledge of Elsters stock. Andersen argues that, because there was no misrepresentation or omission concerning the value of Elsters stock or Elsters' financial condition, the pledge of Elsters stock cannot be used to sustain jurisdiction under section 10(b). The Banks argue that, to sustain jurisdiction under section 10(b), the fraud must merely "touch upon" the sale, not relate to the value of the pledged securities. According to the Banks, this requirement has been satisfied. The Court agrees with the Banks.

The seminal case on the "in connection with" requirement is *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971).

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27. The 1933 Act defines the term sale to include "every contract of sale or disposition of a security or interest in a security, for value," and defines the term offer to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." 1933 Act § 2(3), 15 U.S.C. § 77b(3) (1976). In *Rubin*, the Supreme Court held that this definition encompassed a pledge because "[o]btaining a loan secured by a pledge of shares of stock unmistakably involves a 'disposition of [an] interest in a security, for value.' Although pledges transfer less than absolute title, the interest thus transferred nonetheless is an 'interest in a security.'" 449 U.S. at 429, 101 S.Ct. at 701. The *Rubin* Court also found that, from a policy standpoint, there was no reason to distinguish between a pledgee and a purchaser of stock because, when a pledgee makes a loan and accepts a pledge of stock as security, he is taking an investment risk identical to the risk taken by investors who purchase shares of stock. *Id.* at 431, 101 S.Ct. at 702; *accord, United States v. Gentile, supra,* 530 F.2d at 466-67.

The same result was reached by the Second Circuit in the context of section 10(b). In *Mallis v. Federal Deposit Insurance Corp., supra,* the Second Circuit noted that the rationale underlying the *Gentile* decision—that there is no reason to distinguish between a pledgee and a purchaser of stock because the investment risks are identical—"is persuasive authority for holding that a pledge constitutes [a sale under the 1934 Act]." 568 F.2d at 830.

The facts of *Superintendent of Insurance* can be summarized as follows. As part of a scheme to take control of the Manhattan Casualty Company, several defendants induced Manhattan's Board of Directors to sell its United States Treasury Bonds for approximately $5 million. The defendants, however, misappropriated the money and used it to purchase all of Manhattan's stock. Manhattan, through New York's Superintendent of Insurance, sued for violations of section 10(b) and section 17(a). The District Court dismissed the complaint, and the Second Circuit affirmed, holding, *inter alia*, that there was no fraud "in connection with" the sale of the Treasury Bonds. The Second Circuit noted that,

> [w]hat distinguishes the fraud perpetrated on Manhattan in this case from one cognizable under Rule 10b-5 is that its sole object was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators. No doubt the deception was successful, for had the board known that Sweeny and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale. But that deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded. Indeed, it is no part of the liquidator's claim that the full and fair market price was not paid for those bonds by their purchaser. The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received.

Superintendent of Insurance v. Bankers Life & Casualty Co., 430 F.2d 355, 360 (2d Cir.1970) (citations omitted).

The Supreme Court reversed, holding that the fraud was "in connection with" the sale of the Treasury Bonds. 404 U.S. at 12, 92 S.Ct. at 168. Writing for a unanimous Court, Justice Douglas noted that "[s]ection 10(b) must be read flexibly, not technically and restrictively." *Id.* Because "Manhattan suffered an injury as a result of deceptive practices touching its sale of securities," it had a cause of action under the securities laws. *Id.* at 12-13, 92 S.Ct. at 168-169.

Superintendent of Insurance and its progeny require a nexus, albeit not a direct or close relationship, between the allegedly fraudulent conduct and the sale of securities. *Brown v. Ivie,* 661 F.2d 62, 65 (5th Cir.1981), *cert. denied,* 455 U.S. 990, 102 S.Ct. 1614, 71 L.Ed.2d 850 (1982); *Ketchum v. Green,* 557 F.2d 1022, 1028 (3d Cir.), *cert. denied,* 434 U.S. 940, 98 S.Ct. 431, 54 L.Ed.2d 300 (1977). Stated otherwise, the fraudulent conduct must "touch upon" the securities transaction. *United States v. Newman,* 664 F.2d 12, 18 (2d Cir.1981); *Brown v. Ivie, supra,* 661 F.2d at 65; *Mansbach v. Prescott, Ball & Turben,* 598 F.2d 1017, 1028 (6th Cir.1979); *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath,* 516 F.2d 811, 815 (2d Cir.1975); *see Superintendent of Insurance v. Bankers Life & Casualty Co., supra,* 404 U.S. at 12-13, 92 S.Ct. at 168-169. This has been called the " 'de minimis touch test,' " *Mansbach v. Prescott, Ball & Turben, supra,* 598 F.2d at 1028 (quoting Note, *The Pendulum Swings Farther: The "In Connection With" Requirement and Pretrial Dismissals of Rule 10b-5 Private Claims for Damages,* 56 Tex.L.Rev. 62, 66 (1977)), primarily because it does not take much of a "touch" to satisfy the test. *See* 1 A. Bromberg & L. Lowenfels, Securities Fraud and Com-

modity Fraud § 4.7(574)(3), at 88.34 (1979) (only a "very tenuous" connection need be shown). Indeed, one commentator has noted that

> [t]he "in connection with" clause would ordinarily be fulfilled if a securities transaction is involved in some way, even though the fraud did not occur in the purchase or sale that is attacked (assuming the fraud and securities transaction can be integrated into the same scheme), the deceit did not concern the terms of the securities transaction, the claimant was not a party to the deceptive transaction, the fraud and the loss were merely indirectly connected, the securities transaction was only tangentially related to the fraudulent course of conduct, and the fraud was not aimed at causing a purchase or sale of a security.

5 A. Jacobs, Litigation and Practice Under Rule 10b-5, § 38.01[b], at 2-43 to 2-44 (2d ed. 1981). The practical result of this broad test has been that, since *Superintendent of Insurance*, few courts have found the relationship between the fraud and the sale to be too attenuated or remote to support a claim under section 10(b). *Mansbach v. Prescott, Ball & Turben, supra*, 598 F.2d at 1028.

The Second Circuit has consistently adhered to the teachings of *Superintendent of Insurance*, *United States v. Newman, supra*, 664 F.2d at 18, and, like other courts, has liberally construed the "in connection with" requirement. *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath, supra*, is a good example. In that case, the plaintiff lost several million dollars on securities transactions made by one Yamada in his capacity as the plaintiff's investment adviser. To recoup some of its losses, the plaintiff sued the defendant accounting firm under section 10(b), alleging that the firm misrepresented the finan-

cial condition of Takara Partners, an investment fund managed by Yamada, to induce the plaintiff to retain Yamada and his company to manage part of its portfolio. There was no allegation that the defendant misstated the financial condition of the companies whose securities were traded. The Second Circuit held that the allegations in the complaint were sufficient to meet the "in connection with" requirement because the "[p]laintiff . . . alleged a fraudulent scheme the accomplishment of which is directly related to the trading process." *Id.* at 815; *see United States v. Newman, supra,* 664 F.2d at 18.

Andersen's argument that the fraud must relate to the value of the securities finds no support in the case law. The argument appears to be premised on language in *Rubin* and *Gentile* concerning the identical investment risks taken by a pledgee and a purchaser of stock. *See Rubin v. United States, supra,* 449 U.S. at 431, 101 S.Ct. at 702; *United States v. Gentile, supra,* 530 F.2d at 467. For example, Andersen points to the Supreme Court's statement that "[b]oth [a pledgee and a purchaser of stock] are relying on the value of the securities themselves, and both must be able to depend on the representations made by the transferor of the securities," 449 U.S. at 431, 101 S.Ct. at 702; argues that, "when the Supreme Court referred to 'the representations made by the transferor of the securities,' it meant representations as to the *securities* transferred, and not representations as to the transferor," Memorandum of Law of Defendant Arthur Andersen & Co. in Support of Motion to Dismiss and for Summary Judgment at 30; and concludes that the Supreme Court made clear that the borrower in a pledge transaction (and presumably the seller in an outright sale of a security) can be liable under

the securities laws only if he fails to disclose accurate information about the pledged securities. The problem with Andersen's argument, however, is that the passages relied upon have been taken out of context. The discussion in *Rubin,* and the similar discussion in *Gentile,* concerned only whether a pledge of stock was a sale. Both courts were simply saying that, because the investment risk taken by a pledgee is identical to the investment risk taken by a purchaser of shares of stock, there is no reason to treat a pledge differently than an outright sale of stock for purposes of the antifraud provisions of the securities laws. If more was intended, it was not indicated.

Perhaps the Supreme Court will, when confronted with the issue, narrow the test for determining whether the "in connection with" requirement has been satisfied since there are undoubtedly many instances in which the liberal interpretation of the requirement allows use of the securities laws in what are merely state law commercial disputes.[28]

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28. In *Rubin v. United States, supra,* the Supreme Court noted the question "whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of § 17(a) [of the 1933 Act]," but did not decide it and did not give any indication of how it would be decided. *Id.* at 429 n. 6, 101 S.Ct. at 701 n. 6. This Court need not decide it either. The Banks have alleged that Andersen's conduct violated both § 10(b) of the 1934 Act and § 17(a) of the 1933 Act. In light of our conclusion that the "in connection with" requirement of § 10(b) has been satisfied, there is little practical point in deciding whether the pledge of Elsters stock also supports the exercise of jurisdiction under § 17(a). The Court is especially reluctant to do so because there appear to be few, if any, cases dealing directly with the question of how close a connection between the alleged fraud and the security transaction is necessary under § 17(a). It should be noted, however, that the language of § 17(a) may require a closer nexus than that required under § 10(b)—§ 17(a) proscribes fraud "in the offer or sale of [a security];" § 10(b) proscribes fraud "in connection with the purchase or sale of [a security]." Thus, it is conceivable that the Supreme Court could require that the fraud relate to the securities themselves in the context of § 17(a), but not in the context of § 10(b).

Until it does, however, the Court must adhere to Supreme Court and Second Circuit precedent and utilize the broad touch test. *See Kaufman and Broad, Inc. v. Belzberg,* 522 F.Supp. 35, 41 (S.D.N.Y.1981) ("This Court has neither the inclination nor the effrontery to ignore or defy the applicable rulings of the Court of Appeals in this Circuit.").

Application of the "touch test" to the facts of this case[29] leads to the conclusion that the "in connection with" requirement of section 10(b) has been satisfied. The Banks, in their complaint and supporting affidavit, allege that the pledge of Elsters stock was inextricably entwined with the other parts of the August 1977 transaction. More importantly, they allege that, in deciding whether to advance the money to Elsters, Frigitemp's wholly owned subsidiary, and accept Frigitemp's guarantee and pledge of Elsters stock, they relied on the financial statements prepared and certified by Andersen and that, but for the presentation of Frigitemp as a financially healthy company, they would not have accepted Frigitemp's guarantee and pledge of Elsters stock. Unquestionably, the Banks do not allege that there were any misrepresentations concerning the value of Elsters stock. In view of the breadth of the "touch test" and in view of the Banks' allegation that they would not have entered into the transaction if the truth about Frigitemp were known, however, the Court cannot say, as a matter of law, that the alleged fraud did not "touch upon" the pledge of Elsters stock. Thus, the Court holds that the pledge is sufficient to sustain jurisdiction over the transactions at

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29. Interestingly, Andersen does not argue that the "touch test" was not satisfied in this case. It simply asserts that there can be no violation of the securities laws if the alleged fraud did not directly relate to the value of the securities.

issue.[30] *See Weaver v. Marine Bank,* 637 F.2d 157, 163 (3d Cir.1980) (on analogous facts, the Third Circuit held that the "in connection with" requirement was satisfied), *rev'd on other grounds,* 455 U.S. 551, 102 S.Ct. 1220, 71 L.Ed.2d 409 (1982).[31]

II. *Legal Sufficiency of the Complaints*

The second part of Andersen's motion raises the question whether the Banks' first and fourth claims—that An-

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30. Although the August 1977 transaction can be divided into several parts, it really should be viewed as one integrated transaction. Thus, the Court believes that either the notes or the shares pledged to the Banks are sufficient to support the exercise of jurisdiction over the entire transaction. *See Bolton v. Gramlich,* 540 F.Supp. 822, 840 (S.D.N.Y.1982).

31. As noted above, *see supra* note 25, the plaintiffs in *Weaver* pledged a conventional certificate of deposit issued by the defendant, a commercial bank, to the defendant to guarantee a loan made by the defendant to another company. Shortly thereafter, the company went bankrupt and could not repay the loan to the bank. The plaintiff sued the bank under § 10(b), alleging that "Bank officers told them [the company] would use the . . . loan as working capital but instead it was immediately applied to pay [the company's] overdue obligations." 102 S.Ct. at 1222. The Third Circuit held, *inter alia,* that the alleged fraud was "in connection with" the pledge of the certificate of deposit, a security according to the Third Circuit, even though the fraud did not relate to the value of the certificate of deposit. 637 F.2d at 163. Although the Supreme Court reversed the Third Circuit's holding that the certificate of deposit was a security, 102 S.Ct. at 1223, it did not address the question whether the alleged fraud was "in connection with" the pledge or give any indication that the Third Circuit's conclusion may have been incorrect. Indeed, it could be argued that the Supreme Court implicitly approved of the result when it said that

> "[t]he Court of Appeals also concluded that the pledge of a security is a sale, an issue on which the federal circuits were split. We held in [*Rubin*] that a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws. Accordingly, in determining whether fraud may have occurred here 'in connection with the purchase or sale of any security,' the only issue now before the Court is whether a *security* was involved."

Id. at 1222 n. 2.

dersen violated the securities laws and that it aided and abetted violations of the securities laws—are legally sufficient.

A. *Primary Liability*

Andersen makes three arguments concerning primary liability. Initially, it argues that, as a matter of law, an independent outside auditor cannot be liable as a primary violator of section 10(b) of the 1934 Act; according to Andersen, it can at most be charged as an aider and abettor of a securities law violation. Second, Andersen argues that the complaint must be dismissed because it merely tracks the language of section 10(b). Finally, Andersen argues that the allegations of the complaint amount only to a claim of negligence and that, therefore, Andersen's scienter has not been adequately pleaded. None of these arguments warrants dismissal of the complaint.

Andersen's initial argument is incorrect. There is no reason why an accounting firm that engages in allegedly fraudulent conduct in violation of the securities laws cannot be held liable for those violations. As one court explained,

> [c]ommonly, in securities fraud actions, a distinction has been drawn between primary and secondary defendants. Those persons or entities owing direct duties to the public are classified as primary wrongdoers and those whose liabilities arise because another has violated the law are classified as secondary wrongdoers.
>
> Accountants may be primary wrongdoers when they [prepare and certify financial statements that] contain misrepresentations or omit to state facts necessary to make what is said not misleading [because] [f]inancial

> statements certified by an accountant for presentation to investors give rise to a direct duty to the public.

Seiffer v. Topsy's International, Inc., 487 F.Supp. 653, 667 (D.Kan.1980) (citation omitted); *accord, McLean v. Alexander*, 599 F.2d 1190, 1195-99 (3d Cir.1979) (although the court held that the requisite scienter was not present, it assumed that an accountant could be liable as a primary violator); *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27, 28-38 (2d Cir.1976) (court upheld judgment against accountants as primary violators of section 10(b)); *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath, supra*, 516 F.2d at 812-15 (section 10(b) action against accountants for preparing false and misleading financial statements allowed to proceed to trial).

The four cases cited by Andersen do not compel a contrary conclusion. Three cases, *Edwards & Hanly v. Wells Fargo Securities Clearance Corp.*, 602 F.2d 478 (2d Cir. 1979), *cert. denied*, 444 U.S. 1045, 100 S.Ct. 734, 62 L.Ed.2d 731 (1980), *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973) (en banc), and *Savino v. E.F. Hutton & Co.*, 507 F.Supp. 1225 (S.D.N.Y.1981), stand only for the proposition that, if one does not engage in "independent fraudulent conduct on which liability could be hinged, [he] may not be held liable as [a] principal." *Id.* at 1241; *see* 602 F.2d at 483; 479 F.2d at 1289. In the fourth case, *Fischer v. Kletz*, 266 F.Supp. 180 (S.D.N.Y.1967), Judge Tyler merely wrote that defendants in securities fraud cases tend "to fall into four general categories[:] . . . insiders, . . . broker dealers, . . . corporations whose stock is purchased or sold by plaintiffs[,] . . . [and aiders and abettors of] . . . a party who falls into one of the first three [categories]."

Id. at 190. Judge Tyler did not say that an accountant could not be liable for fraudulent misrepresentations in a financial statement he prepared and certified.

Andersen's second argument is equally unavailing. Admittedly, the first claim in the complaint does track the language of section 17(a) and section 10(b). The MHT complaint, for example, alleges that Andersen

> employed devices, schemes and artifices to defraud; . . . made untrue statements of material facts, in the Statements and elsewhere, or omitted to state material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; and . . . engaged in acts, practices, and courses of conduct and business which operated or would operate as a fraud or deceit.

MHT Complaint ¶ 27. If that were all that was alleged, Andersen would be correct in asserting that a claim for primary liability is not stated. *See Ross v. A.H. Robins Co.*, 607 F.2d 545, 557 (2d Cir.1979) ("It will not do merely to track the language of Rule 10b-5 and rely on such meaningless phrases as 'scheme and conspiracy' or 'plan and scheme and course of conduct to deceive.' "), *cert. denied*, 446 U.S. 946, 100 S.Ct. 2175, 64 L.Ed.2d 802 (1980). The first claim, however, also incorporates by reference approximately eleven pages of allegations that state with particularity the basis of Andersen's alleged liability under the securities laws. *E.g.*, MHT Complaint ¶¶ 4-25. Inclusive of these allegations in the first claim makes frivolous any argument that the complaint merely tracks the language of section 10(b).

Turning to the scienter argument, the Court notes that Andersen is correct in pointing out that it cannot be liable under section 10(b) for mere negligence. *Ernst & Ernst v.*

Hochfelder, 425 U.S. 185, 193, 96 S.Ct. 1375, 1380, 47 L.Ed.2d 668 (1976); *see Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 472, 97 S.Ct. 1292, 1300, 51 L.Ed.2d 480 (1977). "[A] private cause of action for damages will [not] lie under [section 10(b)] in the absence of any allegations of 'scienter,'" *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 193, 96 S.Ct. at 1380, which, in this circuit, means intent or recklessness.[32] *IIT, An International Investment Trust v. Cornfeld,* 619 F.2d 909, 923 (2d Cir.1980) ("reckless conduct will generally satisfy the *scienter* requirement"); *accord, Sirota v. Solitron Devices, Inc.,* 673 F.2d 566, 575 (2d Cir.1982).

Andersen is incorrect, however, in arguing that the allegations of the complaint amount only to a claim of negligence. The complaint alleges that Andersen knew that financial information contained in the financial statements was materially false and misleading or was so reckless in preparing and certifying the statements that its conduct was tantamount to wilfullness. If the Banks prove either of these allegations—knowledge or recklessness—at trial,[33] they will have satisfied the scienter requirement as it has

32. The Supreme Court has not resolved the question whether recklessness suffices for civil liability under section 10(b). *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at 193 n. 12, 96 S.Ct. at 1381 n. 12 ("We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under [section 10(b)]."); *see Santa Fe Industries, Inc. v. Green, supra,* 430 U.S. at 472, 97 S.Ct. at 1300 (Hochfelder held that "a cause of action under [section 10(b)] does not lie for mere negligence.").

33. The complaints allege that Andersen "knew or should have known" that the financial statements were false and misleading and that Andersen acted in a "grossly negligent and reckless manner" in preparing the statements. If, at trial, the Banks prove only that Andersen "should have known" that the statements were false and misleading or that Andersen was grossly negligent, but not reckless, in preparing the statements, it would not prevail. As a matter of pleading, however, allegations in the disjunctive, when one of the alternatives is legally sufficient, is permissible. *See IIT, An International Investment Trust v. Cornfeld, supra,* 619 F.2d at 924.

been interpreted in this Circuit.[34] Thus, they have alleged scienter sufficiently to state a claim against Andersen as a primary violator of section 10(b), and it would be improvident to conclude at this juncture that there is no set of facts that would entitle the Banks to relief under section 10(b). *See Conley v. Gibson,* 355 U.S. 41, 45-46, 78 S.Ct. 99, 101-102, 2 L.Ed.2d 80 (1957) ("complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief" (footnote omitted)).[35]

B. *Aiding and Abetting Liability*

Andersen makes two arguments concerning the Banks' allegations of aiding and abetting liability: the first is that there is no aiding and abetting liability under the antifraud

34. Andersen mistakenly relies on *Dworman v. Lee,* 83 A.D.2d 507, 441 N.Y.S.2d 90 (1st Dep't 1981), *aff'd,* 56 N.Y.2d 816, 438 N.E.2d 103, 452 N.Y.S.2d 570 (1982), a recent New York case in which the Appellate Division held that a complaint similar to the Banks' complaint did not state a cause of action for fraud. *Id.* at 507, 441 N.Y.S.2d at 91 ("Notwithstanding the nomenclature of the first and second causes sounding in fraud and the language in the third cause of action that defendants 'knew or should have known the falsity of their representations,' we find that the first, second and third causes essentially plead negligence."). Whatever effects *Dworman* may have on this Court's consideration of the state common law claims, it governs neither the pleading requirements of the Federal Rules of Civil Procedure nor the substantive elements of a cause of action under section 10(b).

35. Andersen also argues that § 17(a) of the 1933 Act is inapplicable to independent outside auditors. The Court need not, however, address this issue. The Banks have alleged that Andersen's conduct violated both § 10(b) of the 1934 Act and § 17(a) of the 1933 Act. As we have already ruled that the Banks have stated a claim under § 10(b), there is little practical point in assessing the merits of Andersen's § 17(a) argument. If necessary, it will be considered at a later juncture.

provisions of the securities laws; the second is that the complaint does not adequately plead Andersen's scienter. Neither argument has merit.

A cause of action for aiding and abetting a violation of the antifraud provisions of the securities laws has been recognized in the Second Circuit for many years.[36] *See Sirota v. Solitron Devices, Inc., supra,* 673 F.2d at 575; *IIT, An International Investment Trust v. Cornfeld, supra,* 619 F.2d at 922; *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 47-48 (2d Cir.), *cert. denied,* 439 U.S. 1039, 99 S.Ct. 642, 58 L.Ed.2d 698 (1978). If one knowingly renders substantial assistance "in the achievement of [a] primary violation [of the securities laws]," he can be liable as an aider and abettor. *IIT, An International Investment Trust v. Cornfeld, supra,* 619 F.2d at 922.[37] The only issue on this motion, therefore, is whether the scienter element has been pleaded adequately.[38]

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36. Although, to use Andersen's words, "the Supreme Court . . . may well hold that there is no aiding and abetting liability under the [anti]fraud provisions of the . . . securities laws," Reply Memorandum of Law of Defendant Arthur Andersen & Co. in Support of Motion to Dismiss and for Summary Judgment at 103, it has not yet done so. Until it does, this Court must follow Second Circuit precedent.

37. In *IIT*, the Second Circuit delineated three prerequisites to a finding of aiding and abetting liability:

> (1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party;
>
> (2) "knowledge" of this violation on the part of the aider and abettor; and
>
> (3) "substantial assistance" by the aider and abettor in the achievement of the primary violation.

619 F.2d at 922.

38. In its reply papers, Andersen asserts that it did not render substantial assistance to the alleged primary violators. This, however, is a factual issue that must be resolved at trial.

Although the degree of scienter necessary to establish a primary violation of section 10(b) is fairly well established in this circuit, *see Sirota v. Solitron Devices, Inc., supra,* 673 F.2d at 575; *IIT, An International Investment Trust v. Cornfeld, supra,* 619 F.2d at 923, the degree of scienter necessary to establish aiding and abetting liability is an open question. Actual knowledge, of course, will satisfy the requirement. *See id.* at 923-24. Moreover, recklessness is sufficient when "the alleged aider and abettor owes a fiduciary duty to the defrauded party." *Rolf v. Blyth, Eastman Dillon & Co., supra,* 570 F.2d at 44 (footnote omitted); *see Sirota v. Solitron Devices, Inc., supra,* 673 F.2d at 575; *IIT, An International Investment Trust v. Cornfeld, supra,* 619 F.2d at 923. Whether recklessness is sufficient in the absence of a fiduciary duty, however, has not been resolved.[39] *Sirota v. Solitron Devices, Inc., supra,* 673 F.2d at 575.

Be that as it may, the parameters of the scienter element need not be determined in this case because the Banks allege more than recklessness. In the fourth claim, the Banks allege that "all of the defendants other than Andersen intentionally, wilfully and fraudulently misrepresented to plaintiffs the true and accurate state of the finances of Frigitemp," MHT Complaint ¶ 36, and that "Andersen,

39. At least two judges in this district, however, have held that "recklessness is sufficient to establish scienter [when] . . . an accountant has reason to foresee that his audit or opinion letter will be relied upon by third parties." *Oleck v. Fischer,* [1979] Fed.Sec.L.Rep. (CCH) ¶ 96,898, at 95,699 (S.D.N.Y.1979), *aff'd,* 623 F.2d 791 (2d Cir.1980); *accord, In re Investors Funding Corporation Securities Litigation,* 523 F.Supp. 550, 558 (S.D.N.Y.1980); *see Sirota v. Solitron Devices, Inc., supra,* 673 F.2d at 575 (noting *Oleck* and *Investors Funding*); *see also IIT, An International Investment Trust v. Cornfeld, supra,* 619 F.2d at 924-25.

through its gross negligence and reckless disregard for the accuracy of its statements and opinions concerning the finances of Frigitemp, aided and abetted [these] intentional, wilful and fraudulent misrepresentations." *Id.* ¶ 37. Additionally, the fourth claim, like the first, incorporates by reference approximately eleven pages of allegations that state with particularity the basis of Andersen's alleged liability under the securities laws. Thus, we must read the fourth claim to allege that Andersen, in addition to being reckless, knew or should have known of the misrepresentations in the financial statements and that it knew or should have known that the statements would be relied upon by the Banks.[40] This is sufficient to survive a motion to dismiss. *See IIT, An International Investment Trust v. Cornfeld, supra,* 619 F.2d at 923-24 (allegations that the defendants "aided and abetted and joined in the conspiracy by circulating a prospectus which they knew, or should have known, contained material misrepresentations of facts and material omissions" were sufficient as a "matter of pleading."). Whether the Banks can indeed prove such knowledge will have to await trial.

Conclusion

Although the Court believes that the present state of the law in this circuit precludes dismissal of the Banks' claims under the securities laws, it recognizes that there is substantial ground for difference of opinion on the jurisdictional questions—whether the Replacement Notes are securities and whether the pledge of Elsters stock is sufficient to support jurisdiction over this lawsuit. Because these are

40. As noted above, the allegation "knew or should have known" is sufficient as a matter of pleading. *IIT, An International Investment Trust v. Cornfeld, supra,* 619 F.2d at 924; *see supra* note 33.

controlling legal questions, it appears that an immediate appeal from this decision will materially advance the ultimate termination of this litigation. Consequently, the Court will certify an interlocutory appeal on the jurisdictional questions pursuant to 28 U.S.C. § 1292(b) (1976), and will stay further proceedings pending the outcome of the appeal.

SO ORDERED.

APPENDIX D

Order of the United States Court of Appeals for the Second Circuit Denying Rehearing, dated March 21, 1984

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 21st day of March one thousand nine hundred and eighty-four.

No. 83-7290

CHEMICAL BANK,
Plaintiff-Appellee,

v.

ARTHUR ANDERSON & Co., et al.,
Defendants,

ARTHUR ANDERSEN & Co.,
Defendant-Appellant,

MANUFACTURERS HANOVER TRUST COMPANY, etc.,
Plaintiffs-Appellees,

v.

ARTHUR ANDERSEN & Co., et. al.,
Defendants,

ARTHUR ANDERSEN & Co.,
Defendant-Appellant,

SECURITY PACIFIC NATIONAL BANK,
Plaintiff-Appellee,

v.

ARTHUR ANDERSEN & Co., et. al.,
Defendants,

ARTHUR ANDERSEN & Co.,
Defendant-Appellant.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the plaintiffs-appellees, Manufacturers Hanover Trust Company, etc.,

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

/s/ ELAINE B. GOLDSMITH

Elaine B. Goldsmith,
Clerk

APPENDIX E

Order of the Hon. Thurgood Marshall Granting Petitioners' Application for an Extension of Time, dated June 6, 1984

SUPREME COURT OF THE UNITED STATES

No. A-993

CHEMICAL BANK,

Petitioner,

v.

ARTHUR ANDERSEN & Co.

MANUFACTURERS HANOVER TRUST COMPANY AND FIRST PENNSYLVANIA BANK, N.A.,

Petitioners,

v.

ARTHUR ANDERSEN & Co.

SECURITY PACIFIC NATIONAL BANK,

Petitioner,

v.

ARTHUR ANDERSEN & Co.

ORDER

UPON CONSIDERATION of the application of counsel for the petitioners,

IT IS ORDERED that the time for filing a petition for a writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including August 18, 1984.

/s/ THURGOOD MARSHALL

Associate Justice of the
Supreme Court of the United States

Dated this 6th
day of June, 1984.

APPENDIX F

Section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1)

Section 2, Securities Act of 1933, 15 U.S.C. § 77b: Definitions

When used in this subchapter, unless the context otherwise requires—

> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

APPENDIX G

Section 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(3)

Section 3, Securities Act of 1933, 15 U.S.C. § 77c: Classes of securities under this title.

Exempted Securities

(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

* * *

(3) Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited;

APPENDIX H

Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a)

Section 17, Securities Act of 1933, 15 U.S.C. § 77q: Fraudulent interstate transactions

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

* * *

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

APPENDIX I

Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10)

Section 3, Securities Exchange Act of 1934, 15 U.S.C. § 78c: Definitions and application

(a) When used in this chapter, unless the context otherwise requires—

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based

on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

APPENDIX J

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)

Section 10, Securities Exchange Act of 1934, 15 U.S.C. § 78j: Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

APPENDIX K

Rule 10b-5, 17 C.F.R. § 240.10b-5

Rule 10b-5, 17 C.F.R. § 240.10b-5: Employment of manipulative and deceptive devices.

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

APPENDIX L

Opinion of the United States Supreme Court in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971)

SUPERINTENDENT OF INSURANCE OF NEW YORK *v.* BANKERS LIFE & CASUALTY CO. ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 70-60. Argued October 13, 1971—Decided November 8, 1971.

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

Manhattan Casualty Co., now represented by petitioner, New York's Superintendent of Insurance, was, it is alleged, defrauded in the sale of certain securities in violation of § 17(a) of the Securities Act of 1933, 48 Stat. 84, 15 U. S. C. § 77q(a), and of § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U. S. C. § 78j(b). The District Court dismissed the complaint, 300 F. Supp. 1083, and the Court of Appeals affirmed, by a divided bench. 430 F. 2d 355. The case is here on a petition for a writ of certiorari which we granted, 401 U. S. 973.

It seems that Bankers Life & Casualty Co., one of the respondents, agreed to sell all of Manhattan's stock to one Begole for $5,000,000. It is alleged that Begole conspired with one Bourne and others to pay for this stock, not out of their own funds, but with Manhattan's assets. They were alleged to have arranged, through Garvin, Bantel & Co.—a note brokerage firm—to obtain a $5,000,000 check from respondent Irving Trust Co., although they had no funds on deposit there at the time. On the same day they

purchased all the stock of Manhattan from Bankers Life for $5,000,000 and as stockholders and directors, installed one Sweeny as president of Manhattan.

Manhattan then sold its United States Treasury bonds for $4,854,552.67.[1] That amount, plus enough cash to bring the total to $5,000,000, was credited to an account of Manhattan at Irving Trust and the $5,000,000 Irving Trust check was charged against it. As a result, Begole owned all the stock of Manhattan, having used $5,000,000 of Manhattan's assets to purchase it.

To complete the fraudulent scheme, Irving Trust issued a second $5,000,000 check to Manhattan which Sweeny, Manhattan's new president, tendered to Belgian-American Bank & Trust Co. which issued a $5,000,000 certificate of deposit in the name of Manhattan. Sweeny endorsed the certificate of deposit over to New England Note Corp., a company alleged to be controlled by Bourne. Bourne endorsed the certificate over to Belgian-American Banking Corp.[2] as collateral for a $5,000,000 loan from Belgian-American Banking to New England. Its proceeds were paid to Irving Trust to cover the latter's second $5,000,000 check.

Though Manhattan's assets had been depleted, its books reflected only the sale of its Government bonds and the purchase of the certificate of deposit and did not show that its assets had been used by Begole to pay for his purchase of Manhattan's shares or that the certificate of deposit had

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1. Manhattan's Board of Directors was allegedly deceived into authorizing this sale by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value.

2. Belgian-American Banking at the same time made a loan to New England Note in the amount of $250,000 which was distributed in part as follows: Belgian-American Banking $100,000, Bourne $50,000, Begole $50,000, and Garvin, Bantel $25,000.

been assigned to New England and then pledged to Belgian-American Banking.

Manhattan was the seller of Treasury bonds and, it seems to us, clearly protected by § 10(b), 15 U. S. C. § 78j(b), of the Securities Exchange Act,[3] which makes it unlawful to use "in connection with the purchase or sale" of any security "any manipulative or deceptive device or contrivance" in contravention of the rules and regulations of the Securities and Exchange Commission.[4]

There certainly was an "act" or "practice" within the meaning of Rule 10b-5[5] which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds. To be sure, the full market price was paid for those bonds; but the seller was duped into believing that it, the seller,

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3. Section 10(b) provides:

"It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

4. Rule 10b-5, 17 CFR § 240.10b-5, provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

5. N. 4, *supra*.

would receive the proceeds. We cannot agree with the Court of Appeals that "no investor [was] injured" and that the "purity of the security transaction and the purity of the trading process were unsullied." 430 F. 2d, at 361.

Section 10(b) outlaws the use "in connection with the purchase or sale" of any security[6] of "any manipulative or deceptive device or contrivance." The Act protects corporations as well as individuals who are sellers of a security. Manhattan was injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities.

The fact that the fraud was perpetrated by an officer of Manhattan and his outside collaborators is irrelevant to our problem. For § 10(b) bans the use of any deceptive device in the "sale" of any security by "any person." And the fact that the transaction is not conducted through a securities exchange or an organized over-the-counter market is irrelevant to the coverage of § 10(b). *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 201. Likewise irrelevant is the fact that the proceeds of the sale that were due the seller were misappropriated.[7] As the Court

6. Section 3(a)(10) of the 1934 Act defines "security" very broadly (see *Tcherepnin* v. *Knight*, 389 U.S. 332) and clearly embraces Treasury bonds.

7. See, *e. g.*, *Allico Nat. Corp.* v. *Amalgamated Meat Cutters & Butcher Workmen of North America*, 397 F. 2d 727 (CA7 1968), which held sufficient under § 10(b) and Rule 10b-5 a complaint which charged that defendant union, upon discovering that a third party would pay a higher price, breached a prior agreement to sell 100% of the stock in a wholly owned life insurance company to plaintiffs. The court placed primary reliance on the fact that in the course of the transaction, the union misappropriated some 25,000 shares of the life insurance company's stock which had previously been sold to plaintiffs for cash, but which were being held in escrow pending consummation of the agreement.

(footnote continued on next page)

of Appeals for the Fifth Circuit said in the *Hooper* case, "Considering the purpose of this legislation, it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets for its 700,000 shares of stock has suffered no loss if what it gave up was $700,000 but what it got was zero." 282 F. 2d, at 203.

The Congress made clear that "disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web" along with manipulation, investor's ignorance, and the like. H. R. Rep. No.

"Even if a breach of contract in order to make a more favorable contract would not in itself be sufficient [to confer jurisdiction under § 10(b)], we have more here. The motivation not only is said to induce a breach of contract . . . but also to induce the conversion of plaintiffs' pledged 25,000 shares." *Id.*, at 729-730. See also *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (SDNY 1964), in which a conspiracy to loan plaintiff money to buy securities, followed by the misappropriation of the purchased securities when they were pledged to secure the loan, was held to violate § 10(b) and Rule 10b-5.

Indeed, misappropriation is a "garden variety" type of fraud compared to the scheme which gave rise to *A. T. Brod & Co.* v. *Perlow*, 375 F. 2d 393 (CA2 1967). That case involved an action by a broker against its own customers for the recovery of losses suffered when defendant customers refused to pay for securities previously ordered which had decreased in value by the settlement date. The complaint charged that this refusal to honor the purchase order was part of the customers' deceptive plan only to pay for securities purchased for their account when those securities had appreciated in value by the date payment was due.

Rejecting the customers' pleas that "no fraud is alleged as to the investment value of the securities nor any fraud 'usually associated with the sale or purchase of securities,'" *id.*, at 396, the Court of Appeals for the Second Circuit—composed of a different panel from the one sitting in the instant case—reversed the District Court's dismissal of the complaint.

"[We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *Id.*, at 397.

1383, 73d Cong., 2d Sess., 6. Since practices "constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers" in the regulatory agency "have been found practically essential." *Id.*, at 7. Hence we do not read § 10(b) as narrowly as the Court of Appeals; it is not "limited to preserving the integrity of the securities markets" (430 F. 2d, at 361), though that purpose is included. Section 10(b) must be read flexibly, not technically and restrictively. Since there was a "sale" of a security and since fraud was used "in connection with" it, there is redress under § 10(b), whatever might be available as a remedy under state law.

We agree that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face. And the fact that creditors[8] of the defrauded corporate buyer or seller of securities may be the ultimate victims does not warrant disregard of the corporate entity. The controlling stockholder owes the corporation a fiduciary obligation—one "designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders." *Pepper* v. *Litton*, 308 U. S. 295, 307.

The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor. As stated in *Shell* v. *Hensley*, 430 F. 2d 819, 827:

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8. The history of the Act shows that Congress was especially concerned with the impact of frauds on creditors of corporations. See H. R. Rep. No. 1383, 73d Cong., 2d Sess., 3-4.

> "When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5[9] is available as a remedy for the corporate disability."

The case was before the lower courts on a motion to dismiss.

Bankers Life urges that the complaint did not allege, and discovery failed to disclose, any connection between it and the fraud and that, therefore, the dismissal of the complaint as to it was correct and should be affirmed. We make no ruling on this point.

The case must be remanded for trial. We intimate no opinion on the merits, as we have dealt only with allegations and with the question of law whether a cause of action as respects the sale by Manhattan of its Treasury bonds has been charged under § 10(b).[10] We think it has been so

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9. It is now established that a private right of action is implied under § 10(b). See 6 L. Loss, Securities Regulation 3869-3873 (1969); 3 L. Loss, Securities Regulation 1763 *et seq.* (2d ed. 1961). Cf. *Tcherepnin* v. *Knight*, 389 U. S. 332; *J. I. Case Co.* v. *Borak*, 377 U. S. 426.

10. Petitioner's complaint bases his single claim for recovery alternatively on three different transactions alleged to confer jurisdiction under § 10(b): Manhattan's sale of the Treasury bonds; the sale of Manhattan stock by Bankers Life to Bourne and Begole; and the transactions involving the certificates of deposit. We only hold that the alleged fraud is cognizable under § 10(b) and Rule 10b-5 in the bond sale and we express no opinion as to Manhattan's standing under § 10(b) and Rule 10b-5 on other phases of the complaint. See Kellogg, The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 is Involved, 20 Buffalo L. Rev. 93 (1970); Lowenfels, The Demise of the *Birnbaum* Doctrine: A New Era For Rule 10b-5, 54 Va. L. Rev. 268 (1968).

charged and accordingly we reverse and remand for proceedings consistent with this opinion.

All defenses except our ruling on § 10(b) will be open on remand.

Reversed.

APPENDIX M

Opinion of the United States Court of Appeals for the Second Circuit in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 430 F.2d 355 (2d Cir. 1970)

SUPERINTENDENT OF INSURANCE OF the STATE OF NEW YORK, as Liquidator of Manhattan Casualty Company,
Plaintiff-Appellant,

v.

BANKERS LIFE AND CASUALTY COMPANY, Irving Trust Company, Belgian American Banking Corporation, Belgian American Bank & Trust Company, Garvin, Bantel & Company, George K. Garvin,
Defendants-Appellees.

No. 631, Docket 33869.

United States Court of Appeals,
Second Circuit.

Argued March 26, 1970.

Decided July 22, 1970.

Before LUMBARD, Chief Judge, HAYS, Circuit Judge, and BLUMENFELD, District Judge.*

BLUMENFELD, District Judge:

Appellant Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company

* Of the District of Connecticut, sitting by designation.

(Manhattan), commenced this action in 1963 alleging violations by ten defendants of § 17(a) of the Securities Act of 1933. On September 10, 1968, defendants Bankers Life and Casualty Company (Bankers Life), Belgian American Bank & Trust Company (Belgian Trust), and Belgian American Banking Corporation (Belgian Banking) moved to dismiss the action before the late Judge Herlands. On October 1, 1968, defendants Irving Trust Company (Irving), Garvin, Bantel & Company (Garvin, Bantel), and George K. Garvin made similar motions before Judge Ryan. On June 4, 1969, Judge Herlands entered judgment dismissing the action as to Bankers Life, Belgian Trust, and Belgian Banking. His thorough and considered decision granting the motions of these defendants is set out at 300 F.Supp. 1083 (S.D.N.Y.1969). Shortly thereafter, on June 17, 1969, Judge Ryan, concurring in the reasoning of Judge Herlands' opinion, entered judgment dismissing the action as to Irving, Garvin, Bantel, and George K. Garvin. It is from these judgments that the Superintendent appeals. We affirm.

I. *Facts*

Manhattan was a casualty insurance company wholly owned by defendant Bankers Life and operated by it as a subsidiary. In January 1962 two individuals, defendants Standish T. Bourne and James F. Begole, both now deceased, and not involved in this appeal, agreed to purchase all the stock of Manhattan. On January 19, 1962, a contract was executed between Begole as purchaser and Bankers Life as seller, providing for the sale of the Manhattan stock for $5,000,000 on January 24, 1962. On that day, Begole,

John F. Sweeny[1] and C. Joseph Gunther, an officer of Irving, went to Manhattan's office for the closing. Pursuant to plans made in advance of the closing, Gunther tendered an Irving check for $5,000,000 to an officer of Bankers Life and, in exchange, all of the shares of Manhattan stock were given to Begole.

This transaction between Bankers Life and Begole still remains unchallenged because neither the former, as seller, nor the latter, as buyer, has brought any action seeking damages or any relief, one against the other. In this lawsuit our attention has been shifted away from that conventional purchase and sale of the Manhattan stock to the legerdemain employed by the buyer to obtain the $5,000,000 with which to pay for the stock.[2]

Following the closing, but on the same day, United States Government securities (Treasury bonds) from Manhattan's portfolio were sold[3] and the proceeds, amounting

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1. At oral argument in the district court, it was learned that Manhattan ousted Sweeny from the presidency of Manhattan at about the time that Bankers Life decided to sell the Manhattan stock, and that subsequent to the ouster Sweeny established contact between Begole and Bourne and Bankers Life. Judge Herlands concluded:

> "Probably at that time, Sweeny also arranged with Begole and Bourne that he should be reinstated as president of Manhattan when, and if, Begole and Bourne acquired control of Manhattan." 300 F.Supp. at 1087 and n. 4.

2. The details of financing the purchase of Manhattan stock were apparently the responsibility of Bourne. He engaged the services of defendant George K. Garvin and the latter's firm of money brokers (Garvin, Bantel), who had arranged in advance for the above transaction as well as those to follow.

3. The complaint is silent as to the source of authority for this sale of securities from Manhattan's portfolio. Noting that fact, Judge Herlands stated:

> "Conceivably it was [Sweeny, apparently installed as president of Manhattan after the stock changed hands] who directed

(footnote continued on next page)

to $4,854,552.67, plus enough cash to bring the total to $5,000,000, were credited to an account in the name of Manhattan at Irving, and the $5,000,000 Irving check was then charged against this account. As a result of this first series of transactions, Bankers Life had received $5,000,000 in exchange for the Manhattan stock, Begole and Bourne owned the stock, and Manhattan's assets, having been used to purchase the Manhattan stock, had consequently been reduced by $5,000,000.

In order to conceal the depletion of Manhattan's assets,[4] the individuals now in control of Manhattan had a neatly prepared ruse ready at hand. At Garvin's request, Irving issued a second check for $5,000,000 payable to Belgian Trust. Sweeny, president of Manhattan, used this check

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the Chemical Bank to deliver Manhattan's portfolio of * * * securities to Irving Trust, authorized the sale of these securities, and then transferred Manhattan cash to Irving Trust in order to cover completely the $5,000,000 Irving Trust check payable to Bankers Life." 300 F.Supp. at 1089.

He also noted the possibility that a board of directors might have been named, which in turn met and appointed Sweeny as president and granted him authority to effect the transactions on Manhatan's behalf. *Id.* at 1089 n. 6.

Appellant vigorously contends that this represents a serious misunderstanding of fact vital to his theory of recovery. His contention is that the sale of Treasury bonds was authorized by resolution of the board of directors on the basis of a representation that the sale of bonds and purchase of a certificate of deposit was merely a change in the company's investment portfolio. Although every minute detail of the pretenses used by Begole and his associates to mask their fraudulent activity may not have been adduced from the complaint or from the other parts of the record as augmented after some six years of discovery, we are satisfied that the able district judges overlooked nothing that would affect the character of the claim.

4. The financial ability of corporations engaged in the business of liability insurance to meet claims against its policyholders is subject to regulation under the laws of New York. Their books are open to regular inspection by experts in that business employed by the insurance department of the State of New York.

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to buy a $5,000,000 six-months' certificate of deposit from Belgian Trust payable to Manhattan. That certificate was then endorsed by Sweeny as president of Manhattan to New England Note Corporation (New England) and delivered to Bourne, president of New England. Bourne then endorsed and delivered it to Belgian Banking as collateral for a six-months' $5,000,000 loan from Belgian Banking to New England. The proceeds of this loan were then delivered to Irving to cover its $5,000,000 check drawn to the order of Belgian Trust.

To recapitulate, there were two sets of telescoped transactions—all completed on the same day:

A. All of Manhattan's shares were purchased from Bankers Life for $5,000,000, borrowed from Irving. After thus gaining control of Manhattan, the purchaser sold government bonds out of Manhattan's portfolio and used the proceeds to pay off the loan from Irving.

B. To conceal the above depletion of Manhattan's assets, the new owners of Manhattan and those they put in control arranged for a second loan from Irving for $5,000,000. With this they bought a $5,000,000 certificate of deposit from Belgian Trust in the name of Manhattan, and assigned that to New England (Bourne). New England endorsed it to Belgian Banking as security for a $5,000,000 loan to New England. The proceeds were then used to repay Irving's second loan. However, Manhattan's books reflected only the sale of its government bonds and the purchase of the certificate of deposit. Manhattan's records did not show (1) that the proceeds of the sale of these bonds

were used by Begole to pay for his purchase of Manhattan's shares or (2) that the certificate of deposit had been assigned to New England and by it pledged to Belgian Banking.

The loans and certificates outlined in *B.* were twice renewed. The first renewal was in July 1962. In January 1963, when Belgian Banking refused to renew its loan to New England a similar round robin set of transactions was effected by substituting Marine Midland Trust Company to perform Belgian Banking's role. In April 1963 the New York Insurance Department discovered the inadequacy in Manhattan's assets and placed the company in liquidation.

II. *Appellant's Claims*

The complaint alleges that the foregoing related transactions constituted one or more violations of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a).[5] The district court properly considered as well the applicability to the pleaded facts of

5. Section 17(a) provides:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> "(1) to employ any device, scheme, or artifice to defraud, or
>
> "(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

§ 10(b) of the 1934 Act, 15 U.S.C. § 78j(b)[6] and of S.E.C. Rule 10b-5[7] promulgated thereunder. See Hoover v. Allen, 241 F.Supp. 213, 226 n. 7 (S.D.N.Y.1965). On appeal, appellant claims the pleaded facts, as well as those otherwise contained in the record, establish his right to recover under one or both of these sections for fraud perpetrated (1) in connection with the purchase and sale of the Manhattan stock, (2) in connection with the sale of Treasury bonds from Manhattan's portfolio, and (3) in connection with transactions involving certificates of deposit and occurring after January 24, 1962. We disagree and affirm the decision of the district court.

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6. Section 10(b) provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

7. Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

III. *Sale of Manhattan Stock*

Section 17(a) of the 1933 Act provides a cause of action only for a defrauded purchaser. Schoenbaum v. Firstbrook, 268 F.Supp. 385, 396 (S.D.N.Y.1967), aff'd, 405 F.2d 200 (2d Cir.), rev'd in part on other grounds, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied sub nom. Manley v. Schoenbaum, 395 U.S. 906, 89 S.Ct. 1747, 23 L.Ed.2d 219 (1969). Section 10(b) of the 1934 Act and Rule 10b-5 extend a similar right to a defrauded seller as well as to a purchaser of securities. Greenstein v. Paul, 400 F.2d 580, 581 (2d Cir. 1968); Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir.), cert. denied, 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed. 1356 (1952); see Christophides v. Porco, 289 F.Supp. 403, 406 (S.D.N.Y.1968).[8] Bankers Life was the seller of the Manhattan stock; Begole the purchaser. There is no theory under which Manhattan, in whose shoes this appellant stands, may be regarded as either the purchaser or the seller of Bankers Life's Manhattan stock. Consequently the appellant does not fall within the classes of those for whom a cause of action is created either by § 17(a) of the 1933 Act or § 10(b) of the 1934 Act for damages incurred as a result of that transaction.

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8. Although there has been some judicial expansion of the category of persons who may be considered "purchasers," cf. A. T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967), or "sellers" see Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970, 88 S.Ct. 463, 19 L.Ed.2d 460 (1967); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814, 81 S.Ct. 695, 5 L.Ed.2d 693 (1961), nothing in the cited cases undermines the now well-settled purchaser-seller rule of Birnbaum, especially in view of its recent reaffirmation in Greenstein. But see, Weitzen v. Kearns, 271 F.Supp. 616, 622 (S.D.N.Y. 1967); Entel v. Allen, 270 F.Supp. 60, 69 (S.D.N.Y.1967).

IV. *Sale of Manhattan's Treasury Bonds*

Another thrust of this appeal is that the district court erred in holding that no federal cause of action was stated with respect to the purchase or sale of Treasury bonds from Manhattan's portfolio. Appellant's claim that Manhattan is entitled to federal relief as the defrauded seller of those bonds was presented to the district court only as "amendatory allegations presented in open court and not formally set forth in the complaint." 300 F.Supp. at 1098. Moreover, the alleged facts presented in support of the claim on appeal do not appear anywhere in the complaint. *See* note 3, *supra*. Assuming that they are properly before us, and also that they are true, Kossick v. United Fruit Co., 365 U.S. 731, 732, 81 S.Ct. 886, 6 L.Ed.2d 56 (1961), we hold that appellant has not made out a claim cognizable under the federal Securities Acts.

Briefly stated, appellant's claim is that a majority of the board of directors of Manhattan was deceived by misrepresentations of other members of the board and some of the defendants that the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value; that in fact the certificate of deposit so substituted was collateralized to its full face value in favor of an unrelated corporate entity; and that on the basis of the fraudulent representations, the board was deceitfully induced to authorize the sale of the bonds in exchange for a certificate without value to the corporation.

What distinguishes the fraud perpetrated on Manhattan in this case from one cognizable under Rule 10b-5 is that its sole object was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators. No doubt the deception was successful, for had the board known

that Sweeny and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale. But that deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded. Cf. Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964); Globus, Inc. v. Jaroff, 266 F.Supp. 524 (S.D.N.Y.1967); Simon v. New Haven Board & Carton Co., 250 F.Supp. 297 (D.Conn.1966). Indeed, it is no part of the liquidator's claim that the full and fair market price was not paid for those bonds by their purchaser. The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received.

Rule 10b-5 was not intended to provide a remedy for schemes amounting to no more than "fraudulent mismanagement of corporate affairs." Birnbaum v. Newport Steel Corp., supra, 193 F.2d at 464. The scope of the rule must be assessed in light of the purposes of the legislation from which it derives, which we recently found to be "to promote free and open public securities markets and to protect the investing public from suffering inequities in trading * * *." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968) (en banc), cert. denied sub nom. Coates v. SEC, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969). In that case, we construed the "in connection with" requirement of Rule 10b-5 as follows:

> "Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative his-

> tory of Section 10(b) that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities." *Id.* 401 F.2d at 860.

See Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968), cert. denied, 395 U.S. 903, 89 S.Ct. 1740, 23 L.Ed.2d 217 (1969).

The fraud alleged in this case in no way affected either the securities markets or the investing public. No stockholders were defrauded, no investor injured. The purity of the security transaction and the purity of the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets. Cf. Ruckle v. Roto Am. Corp., *supra,* 339 F.2d at 28.

Despite the power of the Commission to promulgate rules "appropriate in the public interest or for the protection of investors," § 78j(b), the scope of the rule in fact promulgated is expressly limited to protection against fraud or deceit "in connection with the purchase or sale of any security." Rule 10b-5. Although in the broadest sense the public interest is involved when a corporation which is subject to regulation by the state Superintendent of Insurance is defrauded, the public interest cognizable by § 10(b) is limited to preserving the integrity of the securities markets. The civil liabilities provisions of the federal Securities Acts, beginning in 15 U.S.C. § 77*l* were "part of a broad integrated program designed to obtain honest dealings in securities," Wilko v. Swan, 127 F.Supp. 55, 58 (S.D.N.Y.1955), not one to create an unlimited federal right

of action for damages for all who have been defrauded in any area of economic activity. The condition imposed by Rule 10b-5 that the fraud be in connection with the purchase or sale of a security is wholly consistent with that program. Thus, we do not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement.

V. *Transactions Involving Certificates of Deposit*

Appellant also contends that Manhattan was defrauded in connection with both purchases and sales of various six-month certificates of deposit exchanged after January 24, 1962. These transactions, which were integral parts of the scheme[9] to conceal the prior depletion of Manhattan's assets, are sufficiently described in the opinion below and need not be fully restated here. The conclusion we have reached that the sale of Manhattan's Treasury bonds did not present a federal cause of action applies equally to these transactions. The certificates of deposit or their proceeds may have been fraudulently misapplied, but there was no fraud in connection with their purchase or sale. In each instance they were bought and sold for their full face amount.

Since we have considered those facts appellant would include in an amendment of his complaint in reaching our conclusion that a claim for relief under the federal Secu-

9. Although the plaintiff contends that it is clear that liability would attach at any one of a number of junctures along the path that led to the liquidation of Manhattan, it expressly disclaims the right to separate recoveries for each of these "separate and distinct fraudulent schemes."

rities Acts is not alleged, we also affirm the district court's denial of the motion to amend.

Affirmed.

HAYS, Circuit Judge (dissenting):

Plaintiff has succeeded to all the rights of Manhattan and is the proper person to assert those rights. See Hooper v. Mountain States Securities Corp., 282 F.2d 195, 206-207 (5th Cir. 1960), cert. denied, 365 U.S. 814, 81 S.Ct. 695, 5 L.Ed.2d 693 (1961), where plaintiff was the defrauded corporation's trustee in bankruptcy.

Manhattan was the victim of a "scheme * * * to defraud" (Rule 10b-5). Judge Blumenfeld has adequately described that scheme. Since the vital center of the scheme, the vehicle for the perpetration of the fraud, was the sale of Manhattan's stock, it seems to me to be completely unrealistic to say that the fraud was not committed "in connection with the purchase or sale of any security."

This court has repeatedly indicated its intention to give a broad and liberal interpretation to Rule 10b-5 in order to assure that that provision is used to accomplish the beneficent purposes for which the statutes governing sales of securities were enacted. See Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964); Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970, 88 S.Ct. 463, 19 L.Ed.2d 460 (1967); A. T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); S. E. C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied sub nom. Coates v. S. E. C., 394 U.S. 976, 89 S.Ct. 1454 (1969); Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied sub nom. Manley v. Schoenbaum, 395 U.S. 906, 89 S.Ct. 1747, 23 L.Ed.2d 219

(1969); S. E. C. v. Great American Industries, Inc., 407 F.2d 453 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 920, 89 S.Ct. 1770, 23 L.Ed.2d 237 (1969). In our most recent expression on the subject, we said that "[t]he purchase-sale requirement must be interpreted so that the broad design [of the statutes] * * * is not frustrated by the use of novel or atypical methods" and we quoted from S. E. C. v. Texas Gulf Sulphur, *supra,* the following language *inter alia*: "the courts, as they should, have broadly construed the statutory phrase 'in connection with the purchase or sale of any security.'" Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 798 & n. 14 (1969).

In my opinion, the purposes of the statutes would be best accomplished here by recognizing plaintiff's standing to enforce the duties created by those statutes.

APPENDIX N

Opinion of the United States District Court for the Southern District of New York in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 300 F. Supp. 1083 (S.D.N.Y. 1969)

SUPERINTENDENT OF INSURANCE OF the STATE OF NEW YORK, as Liquidator of Manhattan Casualty Company,
Plaintiff,

v.

BANKERS LIFE AND CASUALTY COMPANY, Irving Trust Company, Belgian American Banking Corporation, Belgian American Bank & Trust Company, Garvin, Bantel & Company, New England Note Corporation, George K. Garvin, John F. Sweeny, the Estate of Standish T. Bourne, by Standish T. Bourne, Jr., as Executor, the Estate of James F. Begole, by Patricia C. R. Begole, Executrix,
Defendants.

No. 63 Civ. 2490.

United States District Court
S. D. New York.

June 3, 1969.

OPINION

HERLANDS, District Judge:

The issue for decision is another illustration of the recurring problem whether plaintiff's claim belongs in the

state courts or whether plaintiff has stated a cause of action under the federal securities laws—the Securities Act of 1933 (1933 Act), 15 U.S.C. § 77a et seq. (1964) and the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. § 78a et seq. (1964), and the pertinent rules and regulations of the Securities and Exchange Commission. This question is posed by motions made by three of the defendants to dismiss the complaint.

The movants are defendants Bankers Life and Casualty Company ("Bankers Life"), Belgian American Banking Corporation ("Belgian American Banking"), and Belgian American Bank and Trust Company ("Belgian American Trust").

The grounds of the motions are (1) that there is lack of jurisdiction over the subject matter; (2) that the complaint fails to state a claim upon which relief can be granted; and (3) that plaintiff lacks the requisite standing to recover damages for alleged violations of the 1933 and 1934 Acts.

Defendants maintain that plaintiff may not recover because (i) it[1] is neither a defrauded purchaser nor a defrauded seller of securities within the meaning of the 1933 and 1934 Acts, and (ii) these federal statutes have never been and should not be interpreted so as to make them applicable to remedy the injury allegedly resulting from the facts asserted in the complaint. A comprehensive restatement of the facts alleged in the complaint is requisite for

1. The Superintendent of Insurance of the State of New York is the nominal plaintiff. Since he, as Liquidator, has been vested with all rights of the Manhattan Casualty Company (hereinafter "Manhattan"), the rights he seeks to assert are precisely those possessed by Manhattan at the time of his appointment as Liquidator. Consequently, the questions of standing to initiate suit and of injury will be determined as if Manhattan itself had brought suit.

a comprehension of the following discussion of the critical legal issues.[2]

EVENTS PRIOR TO JANUARY 24, 1962

Manhattan Casualty Company ("Manhattan") was a New York corporation engaged in the insurance business. At the beginning of the period under consideration, Bankers Life was the owner of all of the outstanding shares of Manhattan stock. The management of Manhattan apparently was distinct from that of Bankers Life.

During the fall of 1961, Bankers Life decided to discontinue its ownership of Manhattan. Sometime in November, 1961,[3] Bankers Life, through James W. Bourland, a vice-president of Bankers Life, commenced negotiations for the sale of all the Manhattan stock. The prospective purchasers were two individuals, defendants Standish T. Bourne and James F. Begole. (¶ 19).

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2. These motions were made pursuant to an order entered by District Judge Sylvester J. Ryan on June 19, 1968 denying, without prejudice, a motion for summary judgment under Fed.R.Civ.P. 56 (b), (c) because subject matter jurisdiction was doubtful. In light of that motion and its disposition, this Court will not treat the instant motions as motions for summary judgment by looking outside the face of the pleadings. The Court will rule on the questions of jurisdiction and the sufficiency of the complaint solely on the basis of its allegations.

The complaint, however, does not contain "a short and plain statement" (Fed.R.Civ.P. 8(a)) of the claim; its averments are not "simple, concise and direct" (Fed.R.Civ.P. 8(e)); and the intricacies of the pleaded transactions cannot immediately be interrelated.

As a consequence, the Court has been compelled to undertake the task of describing the sequence of events as coherently as the complaint permits. The Court has noted, when necessary, the gaps in the narrative which were filled through other sources (these facts not playing a part in the disposition of the motions) and those gaps which remain void.

3. Paragraph 18 of the complaint alleges that the acts in furtherance of and connection with the scheme to defraud were commenced in November, 1962. However, it is obvious from the succeeding paragraphs that this date is a typographical error, and that the correct date is November, 1961.

At about the time that Bankers Life decided to sell its Manhattan stock, it ousted the defendant John F. Sweeny from the presidency of Manhattan.[4] Sweeny, however, established contact between Begole and Bourne and Bankers Life. Probably at that time, Sweeny also arranged with Begole and Bourne that he should be reinstated as president of Manhattan when, and if, Begole and Bourne acquired control of Manhattan.

The negotiations drew to a successful conclusion. On January 19, 1962, a contract for the purchase and sale of all the Manhattan shares was entered into by Bankers Life (still through Bourland, as its vice-president) and Begole, individually. Begole, alone and in his own name, was to purchase the Manhattan shares. He agreed to deliver to Bankers Life at the closing on January 24, 1962 a bank check or certified check in the amount of $5,000,000. (¶ 20).

The complaint does not charge that any misrepresentations, deceit or nondisclosures had been made or practiced upon any party in connection with this contract of purchase and sale. The complaint is devoid of allegations respecting the net worth of Manhattan or its general financial position; thus, there is nothing upon which to base any finding as to the equity or unfairness of the contract.

Financing

Sometime after January 19, 1962 but before the closing date (January 24, 1962), Bourne had stated to Begole that he, Bourne, would arrange for the financing of the stock acquisition. (¶ 21). Bourne made contact with defendant

4. This information was conveyed to the Court at oral argument (Transcript, September 10, 1968 at 23-25). Sweeny's former relationship with Manhattan, his discharge by Bankers Life, and his subsequent connection with Bourne and Begole, are important for an understanding of the alleged fraud.

George K. Garvin (a partner in the note brokerage firm Garvin, Bantel & Company, also a party defendant) and asked Garvin to have a bank issue certificates of deposit in the face amount of $5,000,000 and then to have a bank make a loan, using the certificates as collateral. (¶ 22). Other than the conclusory statement that the purpose of these two transactions was to conceal the scheme to defraud, there is nothing in the complaint's factual allegations that would explain the significance of these two transactions which, taken together, appear to be self-cancelling.

Acting upon Bourne's request, Garvin, prior to January 24, 1962, arranged with Belgian American Trust to issue a certificate of deposit in the face amount of $5,000,000, in the name of Manhattan. (¶ 23). The complaint is silent, however, as to whether Belgian American Trust was informed of the method of payment for this certificate of deposit. Presumably, it was so informed. Garvin also arranged with Belgian American Banking to loan to defendant New England Note Corporation—a company controlled by Bourne—$5,000,000 upon the collateral of the certificate of deposit that would be issued in the name of Manhattan. (¶ 23).

Also in preparation for the closing of January 24, 1962, Garvin met with C. Joseph Gunther, an officer of defendant Irving Trust Company. Gunther agreed to bring to Garvin's office on January 24, 1962 a check in the amount of $5,000,000 payable to Bankers Life. This check was to be paid for by the delivery of various securities from Chemical Bank New York Trust Company to Irving Trust Company. (¶ 24).

TRANSACTIONS OF JANUARY 24, 1962

The Closing, the Payment for the Manhattan Shares, and the Sale of Manhattan's Portfolio

On the morning of January 24, 1962, Bourne, Sweeny, Begole, and Gunther appeared at Garvin's office. Begole then executed two notes,[5] both payable to New England Note Corporation. One was in the amount of $5,000,000, interest payable at 7½ per cent; the other in the amount of $250,000, interest payable at 5 per cent. The complaint is silent as to whether these notes were delivered. Begole also executed in favor of New England Note Corporation an assignment of the Manhattan stock that he would receive. (¶ 25). The economic purpose underlying these transactions is neither explained nor readily discernible.

Sweeny, Begole, Garvin, and Gunther then went to Manhattan's office for the closing of the sale of Manhattan stock. Gunther handed the $5,000,000 Irving Trust Company check to Leo Lehane, an executive vice-president of Bankers Life, and received in return an unsealed envelope. (¶ 26). The complaint contains no other allegations pertaining to the actual closing. It would be sheer speculation to assume that the envelope did or did not contain the shares of Manhattan stock.

Nevertheless, Begole and Bourne presumably did obtain possession of the shares of Manhattan stock at some point because (as will be detailed later) these shares apparently were physically tendered as security for a loan.

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5. There are no allegations respecting the obligor, *i. e.*, whether these were personal notes of Begole or were to become obligations of Manhattan. It seems more likely that they were personal obligations of Begole because of the assignment of the shares by Begole to New England Note Corporation, which may have been intended as an assignment for security purposes.

Once the ownership of the shares of Manhattan stock apparently changed hands on January 24, 1962, the following took place: United States Government securities owned by Manhattan, in the face amount of $5,155,000, were delivered through Garvin, Bantel & Company to Irving Trust Company.

During the same day of January 24, 1962, Garvin, Bantel & Company sold these securities for Manhattan's account. Irving Trust Company delivered these securities to the purchaser and received the proceeds of $4,854,552.67, which amount it then credited to an account in Manhattan's name.

Manhattan (by some person not named) then transferred some cash to Irving Trust Company, which amount was also credited to this Manhattan account.

Finally, the $5,000,000 check of Irving Trust Company that Gunther had handed to Leo Lehane of Bankers Life was charged against this same Manhattan account in Irving Trust Company (¶ 27)—which had been built up by the crediting of the proceeds of the sale of Manhattan's portfolio of United States Government securities plus the additional Manhattan cash.

The net effect of the foregoing series of financial manoeuvres appears to be, up to this point, as follows:

(i) Bankers Life received $5,000,000 in cash for which it had ostensibly delivered all of its Manhattan stock;

(ii) Presumably, Begole (or possibly Bourne—through New England Note Corporation—as a result of Begole's prior assignment of the Manhattan stock Begole would receive) owned all of the stock of Manhattan;

(iii) Manhattan's portfolio of United States Government securities had been sold off;

(iv) Manhattan transferred some cash to Irving Trust, thereby further building up its account;

(v) Irving Trust applied the total credit—created out of the Manhattan portfolio proceeds and the Manhattan cash—to the payment of the $5,000,000 Irving Trust check which Gunther had given Lehane of Bankers Life;

(vi) As a result, Manhattan's net assets were diminished by approximately $5,000,000; and

(vii) Payment of $5,000,000 to Bankers Life for the purchase of its Manhattan stock was effected by using Manhattan's own assets to pay for all of its stock, which Begole or Bourne thereby obtained without using a dollar of their own money.

Though the complaint is devoid of factual allegations on the point, apparently Sweeny assumed the office of president of Manhattan immediately after the acquisition of the Manhattan shares.[6] Conceivably it was he who directed the Chemical Bank to deliver Manhattan's portfolio of United States Government securities to Irving Trust, authorized the sale of these securities, and then transferred Manhattan cash to Irving Trust in order to cover completely the $5,000,000 Irving Trust check payable to Bankers Life.

The complaint is explicit, however, in charging that Sweeny, in his capacity as president of Manhattan, effected other transactions on January 24, 1962.

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6. In light of allegations that Bourne was required by Irving Trust, through Garvin, to execute certain backdated letters (¶ 32) and that Irving Trust made various entries after January 24, 1962 for the purpose of concealing the transactions of January 24, 1962 (¶ 31), the absence of any similar allegations respecting Sweeny's grant of authority might indicate that Begole, in fact, did immediately name a board of directors, which met and appointed Sweeny as president, granting him sufficient authority to effect the various transactions on Manhattan's behalf.

The Certificates of Deposit

Later that day, Gunther, at the request of Garvin, Bantel & Company, brought another Irving Trust check in the amount of $5,000,000, payable to Belgian American Trust, to the offices of Belgian American Trust. Gunther gave the check to Sweeny who delivered it to someone at Belgian American Trust. Belgian American Trust then issued a six-months certificate of deposit in the amount of $5,000,000 in the name of Manhattan, pursuant to Garvin's prior discussions with Belgian American Trust. Sweeny received the certificate of deposit and, in his capacity as president of Manhattan, immediately endorsed it to New England Note Corporation. (¶ 28).

Bourne, as president of New England Note Corporation, assepted the certificate of deposit from Sweeny; and, in turn, Bourne endorsed the certificate to Belgian American Banking.[7]

Belgian American Banking then made a six-months loan of $5,000,000 to New England Note Corporation and took possession of the certificate of deposit as collateral.

Belgian American Banking drew a $5,000,000 check, apparently payable to Irving Trust Company and delivered it to Gunther. (¶ 28).

To recapitulate for a moment at this point:

(1) Irving Trust Company in effect exchanged its $5,000,000 check payable to Belgian American Trust for a $5,000,000 check drawn by Belgian American Banking, payable to Irving Trust Company.

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7. The exact relationship between Belgian American Banking and Belgian American Trust was never explained in the complaint, nor at oral argument nor in counsel's briefs. It does not appear that, for purposes of these motions, this information is crucial.

(2) Belgian American Trust issued a $5,000,000 certificate of deposit which in reality was paid for by the $5,000,000 emanating from Belgian American Banking in the form of the loan in the same amount made by Belgian American Banking to New England Note Corporation and collateralized by the very same $5,000,000 certificate of deposit of Belgian American Trust.

(3) The certificate of deposit issued by Belgian American Trust was issued in the name of Manhattan, though Manhattan did not pay for it and was in fact only an intermediate conduit for this certificate of deposit as it made its way from Belgian American Trust to Belgian American Banking.

At the same time that Belgian American Banking made the $5,000,000 loan to New England Note Corporation, it made another loan of $250,000 to New England Note Corporation and received as security the Manhattan shares assigned by Begole to New England Note Corporation. (¶ 28). Once again the complaint is not precise and does not allege specifically whether the Manhattan shares were actually delivered to Belgian American Banking.

The proceeds of this $250,000 loan were deposited in Belgian American Trust and the following amounts totalling $225,000 were disbursed: Garvin, Bantel—$25,000; Begole—$50,000; Bourne—$50,000; Belgian American Banking—$100,000. (¶ 28). It would be supposititious to attempt any explanation for the payment of the above $225,000. The complaint does not allege that this transaction constituted fraud, but only that the various transactions with the Belgian American banks were effected for the purpose of concealing the fact that Manhattan's assets had been reduced by the sale of its securities—a fact which

does, indeed, emerge clearly from the above labyrinthine transactions.

EVENTS SUBSEQUENT TO JANUARY 24, 1962

The complaint alleges other events which occurred subsequent to January 24, 1962, such as the making of entries by Irving Trust Company for the purpose of concealing the transactions of January 24, 1962 (¶ 31); and, for similar purposes, the execution by Bourne of various backdated letters which were given to Garvin on January 29, 1962 (¶ 32).

On July 24, 1962, the six-months certificate of deposit matured; the loan by Belgian American Banking to New England Note Corporation and the loans by New England Note Corporation to Begole fell due. Belgian American Trust then issued a new six-months certificate of deposit in Manhattan's name in the amount of $5,000,000. This certificate was endorsed by Begole (as chairman of Manhattan) and Sweeny (as treasurer) and posted as collateral for the Belgian American Banking-New England Note Corporation loans which were then extended to January 24, 1963. (¶ 33). The Manhattan stock at this point appears to be physically in the possession of Belgian American Banking as collateral for the loans. Finally, Begole's loans ($5,000,000 and $250,000) from New England Note Corporation were also extended to January 24, 1963. (¶ 33). It is alleged that these transactions were entered into for the purpose of furthering the scheme to defraud. (¶ 33).

While it would appear from the foregoing that Belgian American Banking was in possession of the $5,000,000 certificate of deposit, on August 30, 1962 Sweeny (in his capacity as president of Manhattan) wrote Belgian American

Trust that he was forwarding to Belgian American Trust a non-negotiable certificate of deposit in the amount of $5,000,000 which was to be paid at maturity into Manhattan's current account at Belgian American Trust. Sweeny also stated that he was forwarding a non-negotiable certificate of deposit in the amount of $500,000 issued by the First National Bank of Boston, which certificate was to be held by Belgian American Trust in safekeeping. There are no allegations respecting the purchaser of this certificate, the source of funds for its issuance, nor any fraudulent activity in connection with it. Again, the complaint alleges that the purpose of this legerdemain was to conceal the actual reduction in Manhattan's assets and to create the misleading impression that Manhattan had $5,500,000 more in unencumbered assets than it, in fact, did have. (¶ 34).

Repayment of Belgian American Banking Loans

Sometime in January, 1963, Belgian American Banking made known that it would not renew or extend its loans to New England Note Corporation, which notes fell due on January 24, 1963. (¶ 35). Accordingly, beginning on or about January 20, 1963, Bourne and Begole initiated another series of camouflaging transactions.

Firstly, Bourne asked Garvin, Bantel to arrange to replace the certificates of deposit which undoubtedly had been carried as assets upon Manhattan's books and the proceeds of which would be required to repay the Belgian American Banking loans. Garvin, Bantel borrowed $5,500,000 from Marine Midland Bank and Trust Co. and delivered the funds to Irving Trust Company. Irving Trust Company, on January 21, 1963, issued, at Begole's request, certificates of deposit in the amount of $5,500,000, apparently with

Manhattan as payee.[8] These certificates were delivered to Garvin, Bantel. (¶ 36).

Secondly, on January 25, 1963, Belgian American Trust credited Manhattan's account with the proceeds and interest of the two certificates of deposit referred to in Sweeny's letter of August 20, 1962—$5,075,616.44 representing the amount credited with respect to the Belgian American Trust certificate of $5,000,000 and $515,361.18 representing the proceeds of the First National Bank of Boston certificate of $500,000. (¶ 37).

At Manhattan's request, Belgian American Trust issued a check in the sum of $5,500,000 to Irving Trust Company and charged Manhattan's account.

Irving Trust Company thereupon drew its own check in favor of Belgian American Banking in the amount of $5,250,000 and charged this amount of $5,250,000 against the credit established by the $5,500,000 check which it had received from Belgian American Trust. The Irving Trust Company check in the amount of $5,250,000 was then applied by Belgian American Banking to the New England Note Corporation loans (of $5,000,000 and $250,000) then due and owing to Belgian American Banking. (¶ 37).

It is alleged that the exchange of checks between Belgian American Trust and Irving Trust Company and between Irving Trust Company and Belgian American Banking took place at the same time at a meeting held on January 25, 1963 at the office of one (or possibly both) of the Belgian American banks. (¶ 37).

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8. Paragraph 36 is silent as to the payee of the Irving Trust certificates. However, since paragraph 39 alleges that Irving Trust certified to the State Insurance Department that it was indebted to Manhattan in the amount of $5,500,000 as evidenced by certificates of deposit, and since the alleged scheme of concealing the diminution of assets would not be effective unless the certificates were in Manhattan's name, it is a reasonable assumption that they were so issued.

As a result of these transactions, it now appeared that Manhattan was the payee of a $5,500,000 certificate of deposit (issued by Irving Trust Company) which, however, had been delivered physically to Garvin, Bantel and then undoubtedly used by Garvin, Bantel as security for its loan of $5,500,000 from Marine Midland Bank.[9]

Manhattan also had approximately $90,000 on deposit in Belgian American Trust representing interest earned by the certificate of deposit and a balance of $250,000 in Irving Trust Company representing the difference between the $5,500,000 check received by Irving Trust Company from Belgian American Trust and the $5,250,000 check issued by Irving Trust Company to Belgian American Banking. There are no allegations respecting interest on the Belgian American Banking-New England Note Corporation loans; and it is likely that Manhattan paid this interest by using the cash balances on deposit in Belgian American Trust and Irving Trust.

Other than these possibilities arising from the interest earned by the certificates of deposit and the interest payable on the loans, the Belgian American banks, as of January 25, 1963, do not figure in any financial transaction.

On April 18, 1963, Belgian American Banking returned to Begole and Sweeny the shares of Manhattan stock which it had received as collateral on the New England Note Corporation loan. (¶ 38).

Finally, on May 15, 1963, allegedly for the purpose of concealing the diminution of Manhattan's assets, Irving

9. There are no allegations, however, regarding the pledge or assignment of this certificate as security nor any allegations regarding an assignment or endorsement by Manhattan of the Irving Trust Company certificate of deposit (of $5,500,000) which presumably would be necessary in order to make this certificate acceptable to Marine Midland Bank as security for Garvin, Bantel's loan.

Trust Company certified to the New York State Insurance Department that Manhattan had on deposit at Irving Trust Company $5,500,000, as evidenced by the certificates of deposit (payable to Manhattan) issued by Irving Trust on January 21, 1963. The certification included statements that the certificates of deposit were free of all liens, claims, or encumbrances and were not held as security for any loan. (¶ 39). These certificates of deposit, as previously noted, had in fact been delivered to Garvin, Bantel.

The net effect of the myriad financial manoeuvres was that an individual (Begole) or a group of individuals (Begole, Bourne, et al.) obtained control of Manhattan by (1) having Irving Trust Company deliver its $5,000,000 check to Bankers Life (the then sole stockholder of Manhattan), (2) receiving all of Bankers Life's shares of Manhattan, and (3) repaying Irving Trust Company by selling Manhattan's portfolio of United States Government securities and forwarding the proceeds plus some additional cash to Irving Trust Company.

In essence, Manhattan's corporate funds that should have been kept available to meet Manhattan's creditors' and policyholders' claims were thus unlawfully used by Begole for the noncorporate, private purpose of enabling Begole (and those in concert with him) to acquire all of Manhattan's shares.

Since Manhattan, a solvent corporation was thereby rendered insolvent, the corporation itself was victimized. But, inasmuch as Begole was Manhattan's sole stockholder, the economic injury was to be borne only by Manhattan's creditors and policyholders.

It is impossible to ascertain with any degree of certainty from the face of the complaint who benefitted from

the transaction. Bourne, Sweeny, Begole, Garvin or all of them in concert, may have masterminded and gained from the scheme. As previously noted, Bourne, Begole, Garvin, Bantel and Belgian American Banking received various amounts of cash, totalling $225,000, originating out of the $250,000 loan by Belgian American Banking to New England Note Corporation.

Indeed, if Manhattan had a net worth on January 24, 1962 substantially below $5,000,000, Bankers Life may have been the ultimate beneficiary. Resolution of this puzzlement is not required to decide the present motions.

PLAINTIFF'S LEGAL THEORY AND MOVANTS' CHALLENGES

Plaintiff claims that these transactions, when integrated, constitute violations of section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) because all of the defendants, by their respective participation, employed a device, scheme and artifice to defraud Manhattan. The precise applicability of section 17(a) is never articulated in the complaint. Nevertheless, plaintiff's apparent position is that the bootstrap acquisition of control by Begole, Sweeny and Bourne whereby Manhattan's assets rather than outside funds were the source of the purchase price of Manhattan's shares was fraudulent insofar as Manhattan was concerned. Moreover, in order to retain control of Manhattan without disclosing the means of financing the acquisition of the Manhattan shares, defendants, as part of the same scheme, finagled records and executed intricate financial transactions to conceal and suppress the truth.

Bankers Life and the two Belgian American banks have moved to test the legal sufficiency of this theory as applied

to the facts alleged in the complaint. More particularly, these defendants seek an order, pursuant to Fed.R.Civ.P. 12(c), (h), granting judgment on the pleadings and dismissing the complaint as to them on the grounds that the Court lacks federal question or diversity jurisdiction; that plaintiff lacks standing to recover damages for violations of section 17(a) of the 1933 Act; and that the complaint fails to state a claim upon which relief can be granted.

In the context of complaints alleging violations of the securities acts, there is no significant distinction between dismissal for lack of jurisdiction and dismissal for failure to state a cause of action. Federal jurisdiction depends on the existence of a federal question, *i. e.*, the violation of a provision of one of the securities acts. Should the Court determine that the facts alleged do not make out a violation of federal law, and consequently fails to state a claim, the Court, in effect, has also determined that there is no federal question, and thus no jurisdiction. *See* Britt v. Cyril Bath Co., 290 F.Supp. 934 (N.D.Ohio 1968). Therefore, the Court will not attempt, as a matter of formal analysis, to deal separately with these two grounds. Because the same issues of law are raised by both grounds, they will be discussed simultaneously.

The Court initially, however, directs its attention to the question of standing which can be decided without reference to the merits of the claim since this attack on the complaint assumes *arguendo* that it does allege an actual violation of the securities acts and that the Court has jurisdiction.

WHO MAY RECOVER FOR ALLEGED VIOLATIONS OF THE ANTI-FRAUD PROVISIONS OF THE SECURITIES ACTS?

Defendants, in their memoranda, claim that plaintiff may not recover for violations of section 17(a) of the 1933 Act because that section gives rise to a cause of action in a defrauded purchaser only, and that it is obvious from the face of the complaint that Manhattan was not a purchaser of its own stock. At oral argument and in its briefs, plaintiff presents a number of arguments in refutation.

Plaintiff's position is that, for purposes of these motions, it is not limited to section 17(a) of the 1933 Act (the only section explicitly alleged to have been violated) but that it is entitled to have the motions denied if it has standing and if it makes out a claim under *any* federal statute. Plaintiff then asserts that section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1964) and S.E.C. Rule 10b-5 are also material; that the complaint does state a cause of action under that section; and that plaintiff has standing to sue for damages resulting from violations of section 10(b) of the 1934 Act and section 17(a) of the 1933 Act.

The Court is not restricted to the particular legal theory of recovery or jurisdictional basis alleged in the complaint. If the facts are alleged with reasonable clarity so as to give adequate notice of the transaction, and if plaintiff is entitled to recover under any legal theory, the complaint is sufficient. 1A Barron & Holtzoff, Federal Practice and Procedure § 276.1 (Wright ed. 1960); 2A J. Moore, Federal Practice ¶ 8.14 (2d ed. 1968).

Moreover, because the operative language of section 10(b) and Rule 10b-5 is so similar to that of section 17(a) of the 1933 Act, the Court will consider the applicability

of these provisions. *See* Hoover v. Allen, 241 F.Supp. 213, 226 n. 7 (S.D.N.Y.1965).

Only a defrauded purchaser may recover under section 17(a) of the 1933 Act. The statute provides:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

This statute was aimed at fraudulent practices by which sellers of securities could defraud or deceive purchasers. The very purpose of the promulgation of Rule 10b-5 under the 1934 Act was to prohibit individuals or companies from buying securities if they engage in fraud in their purchase. The objective of Rule 10b-5 was to make the same prohibitions contained in section 17(a) of the 1933 Act applicable to purchasers as well as to sellers. *See, e. g.,* Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir.), cert. denied, 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed. 1356 (1952); III L. Loss, Securities Regulation at 1423-30 (2d ed. 1961); A. Bromberg, Securities Law: Fraud at 19-20 (1968).

The requirement of being a defrauded purchaser to recover for a violation of section 17(a) has even more recently been upheld. *See, e. g.*, Schoenbaum v. Firstbrook, 268 F.Supp. 385, 396 (S.D.N.Y.1967), aff'd, 405 F.2d 200 (2d Cir.), rev'd on other grounds en banc, 405 F.2d 215 (2d Cir. 1968); Colonial Realty Corp. v. The Curtis Publishing Co., CCH Fed.Sec.L.Rep. ¶ 92,105 (S.D.N.Y.1967); *cf.* Hoover v. Allen, 241 F.Supp. 213, 223 (S.D.N.Y.1965).

Rule 10b-5, however, is more expansive than section 17(a) of the 1933 Act. It prohibits fraud or deception by either a purchaser or seller; and its operative language is "in connection with the purchase or sale of any security" as distinguished from the phrase "in the offer or sale of any securit[ies]" which appears in section 17(a) of the 1933 Act.[10] Nevertheless, the standing requirement appears to

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10. The texts of section 10(b) and Rule 10b-5 are hereafter set forth:

> "Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors."

> "Rule 10b-5. Employment of Manipulative and Deceptive Devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the state-

(footnote continued on next page)

differ only in that defrauded sellers as well as purchasers are included in the permissible class of potential plaintiffs.

In Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956, 72 S.Ct. 1051 (1952), plaintiff sought to prosecute a derivative suit against the former president and major shareholder of the corporation who allegedly had violated section 10(b) and Rule 10b-5 in rejecting, as president, an allegedly favorable merger offer and who then sold his stock to another company at a substantial premium. In affirming the district court's dismissal of the complaint, the court, *inter alia,* held that the action could not be maintained in the corporate name in the absence of an allegation that the plaintiff corporation was either a defrauded purchaser or seller of securities. This holding has been consistently applied. *See, e.g.,* Chashin v. Mencher, 255 F.Supp. 545, 548 (S.D.N.Y.1965) and cases there cited.

Plaintiff contends that *Birnbaum* is no longer controlling doctrine. It argues that recent case law (mostly developed by the Second Circuit) has eroded the validity of *Birnbaum* and the limitation of standing to defrauded purchasers or sellers.

The Court rejects plaintiff's reading of recent decisions. Though there have been, literally, dozens of cases raising the issue since *Birnbaum,* not one has permitted a plaintiff who has been held to be other than a "purchaser or seller" (as those terms have been interpreted) to maintain an action for damages under Rule 10b-5.

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ments made, in light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

In Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960), a case much relied on by plaintiff, the court did permit the trustee in bankruptcy to sue in behalf of a corporation whose stock had been issued, without registration, and then publicly distributed by some of the defendants. Plaintiff alleged a violation of Rule 10b-5 in that the corporation's transfer agent was induced to issue these shares on the basis of fraudulent representations made to the agent by former officers of the bankrupt. The court held that the corporation could maintain its action for the reason that the issuance of stock was a "sale" and since it did not receive full consideration for the valuable shares issued, the corporation was thus a defrauded "seller." *Hooper,* thus, manifestly does not indicate the demise of the purchaser-seller requirement.

Hooper did serve as the genesis for a long string of cases that have permitted corporations to sue for damages when they were the victim of a securities fraud. Yet, in every case, the corporation either qualified as a "seller" since it had issued new shares, or as a purchaser when it redeemed shares or purchased treasury stock.

Other cases are also relied upon by plaintiff to support its thesis that the authority of *Birnbaum* has become attenuated. Ruckle v. Roto American Corporation, 339 F.2d 24 (2d Cir. 1964), upheld the right of a defrauded *issuer* to recover damages because preventing the perpetration of fraud upon an issuer with the consequent distribution of newly issued and watered stock was one of the chief reasons for the enactment of the securities laws. 339 F.2d at 28. Since an "issuer" is a seller (per *Hooper*), this result is not inconsistent with the *Birnbaum* purchaser-seller requirement. And, although *Ruckle* distinguished *Birnbaum* and Howard

v. Furst[11] on the grounds that the corporations in those cases had not sustained injury, it is clear from the rationale for the *Ruckle* decision that the mere existence of corporate injury was not the crucial, decisive factor; the emphasis was on the spread of overvalued securities resulting from the fraud on the corporation.

Nor do the other cases cited by plaintiff support its *Birnbaum* erosion thesis. In Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir. 1967), the court held that a minority shareholder who, pursuant to a short form statutory merger, was forced either to sell his shares to the surviving corporation or to retain shares in a defunct corporation was a "seller", though he retained his shares. The court specifically disclaimed any intention to depart from the traditional purchaser-seller requirement and decided that, under the particular circumstances, plaintiff was, as a practical matter, a seller.

In A. T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967), the court reversed the dismissal of a complaint which charged that defendant had employed a scheme in refusing to pay for securities he had ordered from plaintiff-broker. The court noted, explicitly, that plaintiff in that case was a purchaser and thus there was no need to delve into the question of whether a broader standing requirement should be adopted. 375 F.2d at 397 n. 3.

It is true that *Brod* implicitly criticized *Birnbaum* in the statement: "Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities'. We believe that § 10(b) and Rule

11. 238 F.2d 790 (2d Cir. 1956), cert. denied, 353 U.S. 937, 77 S.Ct. 814, 1 L.Ed.2d 759 (1957) (shareholders may not sue derivatively for injury growing out of S.E.C. proxy rule violations).

10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." 375 F.2d at 397. The language the Court of Appeals believed too limited is that of *Birnbaum.*

An analysis of the decision in *Birnbaum,* however, discloses that there were at least two distinct reasons for dismissing the complaint[12]—the failure of the allegations to state a cause of action, and the lack of standing in the corporation to recover for violations of the securities laws when the corporation was neither a defrauded purchaser nor defrauded seller. The language quoted by *Brod* was the *Birnbaum* court's rationale for dismissal for failure to state a claim; so too, the only issue involved in *Brod* was the question of whether the facts alleged constituted a violation of Rule 10b-5. And thus, while *Brod* must be read as modifying *Birnbaum* on this issue, *Birnbaum's* standing requirements have not been altered.[13]

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12. One commentator has also noted the tendency to confuse the distinct grounds for decision in *Birnbaum* which results from "an uncritical reading of the general language * * *" *See* A. Bromberg, *supra* at 88.1.

13. Though not cited by plaintiff to this Court, two other cases have been relied on as authority for the *Birnbaum* "erosion" or "demise" theory. *See* Lowenfels, The Demise of the Birnbaum Doctrine: A New Era For Rule 10b-5, 54 Va.L.Rev. 268 (1968). In Symington Wayne Corp. v. Dresser Industries, Inc., 383 F.2d 840 (2d Cir. 1967), the court denied, on the grounds of failure to prove irreparable harm, an application for an order enjoining a tender offer allegedly steeped in material misrepresentations and omissions. Though the court reached the merits in a suit brought by the corporation being acquired and two of its shareholders, it specifically refrained from deciding the question of standing. 383 F.2d at 842. In Mutual Shares v. Genesco, 384 F.2d 540 (2d Cir. 1967), the court did decide that one need not be a purchaser or seller in a suit for an injunction,

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Indeed, in Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968), the Court of Appeals appeared to foreclose any argument respecting the demise of the *Birnbaum* purchaser-seller requirement:

> "It has long been the rule in this circuit that to maintain an action under § 10(b) of the [1934] Act and Rule 10b-5 of the Securities and Exchange Commission the plaintiff must have been a seller of the stock involved. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (C.A. 2, 1952), cert. denied 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed. 1356 (1952). Although criticized, Entel v. Allen, 270 F.Supp. 60, 70 (S.D.N.Y., 1967), it is still the rule at least insofar as actions for damages are concerned. Mutual Shares Corp. v. Genesco, Inc., [384 F.2d 540 (C.A. 2)] supra."

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but held, however, that the trial court's dismissal of the damages claim was correct. *See* 384 F.2d at 547. The injunction was against a continuing deceitful manipulation of the market price of publicly-owned stock; and this conduct was held to create a claim under section 10(b) and Rule 10b-5. The Court explicitly stated that the claim for equitable relief required proof of fewer elements than would a claim for damages.

Lowenfels, *supra*, does not distinguish between the two separate grounds for decision in *Birnbaum;* and thus fails to note that *Brod* modifies *Birnbaum* only with respect to the ground based on failure to state a claim.

Weitzen v. Kearns, 271 F.Supp. 616, 622 (S.D.N.Y.1967), and Entel v. Allen, 270 F.Supp. 60, 69 (S.D.N.Y.1967)—both decided by the same judge—apparently also came to the conclusion that *Birnbaum* was "seriously challenged, if not overruled" by reading *Brod* as questioning *Birnbaum's* holding with respect to standing as well as the scope of Rule 10b-5. However, in Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968), the Second Circuit squarely reaffirmed the continuing validity of *Birnbaum* as authority for the rule that to maintain an action for damages under section 10(b) and Rule 10b-5 the plaintiff must have been a seller of the stock involved. *See also* Christophides v. Porco, 289 F.Supp. 403 (S.D.N.Y.1968); Bound Brook Water Co. v. Jaffe, 284 F.Supp. 702 (D.N.J.1968).

EXPANSION OF THE PURCHASER-SELLER REQUIREMENT?

Plaintiff argues that, even if the purchaser-seller requirement has not yet been expressly overruled or broadened, the various cases which were cited by plaintiff for that proposition, and discussed by the Court above, at least indicate discontent with the narrow *Birnbaum* rule, forcing the Court of Appeals to choose other means to circumvent its rigors (e. g., interpreting term "seller" broadly). Plaintiff thus appears to ask this Court to broaden, in an explicit fashion, the standing requirements. Plaintiff refers the Court to the brief of the Securities and Exchange Commission as amicus curiae in Vine v. Beneficial Finance Co., supra, where the S.E.C. argued for such an expansion. Plaintiff argues that this step would eliminate unnecessary complexities, distinctions, and incentives to clever scheming and would achieve greater justice in the individual case. Memorandum of Plaintiff In Opposition to Motions Pursuant to Rules 12(c) and 12(h) Federal Rules of Civil Procedure at 31.

Other reasons have been advanced by commentators for the abandonment of the purchaser-seller prerequisite. *See, e. g.,* Lowenfels, *supra* note 12; Note, The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5, 56 Geo.L.J. 1177 (1968).

The rule that this Court is asked to adopt is that anyone who is injured by a violation of the securities acts may sue to recover damages. The Court declines this invitation to expand the traditional standing requirement.

The Court of Appeals has declined to accede to the repeated requests of plaintiffs and *amici curiae* to enlarge the class of potential plaintiffs in actions for damages arising

out of violations of Rule 10b-5. In light of Greenstein v. Paul, *supra*, the Court does not discern any imminent doctrinal change by the Court of Appeals. In these circumstances, a district judge may not disregard an established principle of law. Accordingly, the Court rules that only a defrauded purchaser or seller may sue for damages arising from a violation of section 10(b) of the 1934 Act and S.E.C. Rule 10b-5.

IS PLAINTIFF A DEFRAUDED PURCHASER OR SELLER OF SECURITIES?

The complaint charges a violation of the anti-fraud provisions of the 1933 Act in the purchase and sale of the shares of Manhattan stock on January 24, 1962. (¶¶ 1, 18, 40). The seller of these shares was Bankers Life and the purchaser was Begole. (¶ 20). From the face of the pleadings, it thus appears that plaintiff—Manhattan—was neither a purchaser nor a seller of the security (shares of Manhattan stock) which was the subject of the alleged fraud.

At oral argument, however, plaintiff's counsel suggested that—in view of the fact that Begole did not furnish any "fresh" consideration for the purchase of the shares and that, ultimately, it was Manhattan's funds which paid for the shares—Manhattan should be considered the purchaser. (Tr. at 30). While it is true that a corporation can be a purchaser of its own stock within the meaning of the securities laws, *see, e. g.*, O'Neill v. Maytag, 230 F.Supp. 235 (S.D. N.Y.), aff'd, 339 F.2d 764 (2d Cir. 1964), a corporation cannot be the purchaser of *all* of its own stock unless the shares were cancelled and a general dissolution occurred. This is so because a corporation cannot maintain its status as a separate or existing entity (or fictional person) without

having another entity or individual serve in the capacity of proprietor or owner.

This Court deems, as a matter of law, the fact that plaintiff may have been the ultimate source of funds for the purchase of Manhattan shares (*i. e.*, the proceeds of the sale of Manhattan's portfolio of United States Government securities were received by Irving Trust Company and credited to Manhattan's account, which thereafter was charged with the $5,000,000 check delivered by Irving Trust Company to Bankers Life) insufficient to establish plaintiff as the purchaser of Manhattan shares because it was never intended that plaintiff would take title to those shares. This Court holds that, insofar as section 17(a) of the 1933 Act and section 10(b) of the 1934 Act are concerned, a purchaser of securities is one who was a party to a transaction whereby he was to assume ownership of securities in exchange for valuable consideration. Under this definition, plaintiff fails to achieve the status of purchaser and, consequently, may not assert a cause of action for a violation of the securities laws with respect to the purchase and sale of the Manhattan shares.

Though the complaint alleges fraud only in the purchase and sale of the Manhattan shares, plaintiff now adopts the new position that, as a purchaser of a certificate of deposit, and as a seller of United States Government securities, plaintiff has standing to sue in this action (Tr. at 32-35).

Without commenting on the propriety of ruling on the sufficiency of a complaint based on amendatory allegations presented in open court and not formally set forth in the complaint, the Court concludes that if, within the meaning of the securities acts, fraudulent schemes were employed in connection with the sale of Manhattan's portfolio of

United States Government securities, plaintiff, *if damaged*, may maintain a suit to recover. Manhattan was a seller of those securities, though management perhaps breached its duties to the corporation in authorizing or ratifying the sale; and, if the corporation was damaged through fraudulent activities, plaintiff may recover damages.

With respect to plaintiff's standing deriving from its alleged "purchase" of various certificates of deposit,[14] the Court is convinced that plaintiff was not a purchaser, despite the fact that it tendered to Belgian American Trust, Irving Trust Company's check for $5,000,000 and received a $5,000,000 certificate of deposit payable to itself. Since, by prearrangement, this certificate was endorsed to New England Note Corporation which delivered it to Belgian American Banking as collateral for the $5,000,000 loan from Belgian American Banking to New England Note Corporation, and the proceeds of this loan were given directly to Irving Trust Company in payment for the $5,000,000 check that had paid for the certificate of deposit, this entire transtion was a "wash" and had no economic reality. As such, Manhattan was not a "purchaser" of a "security" but was merely participating as a conduit for the sole purpose of having its name appear as payee which enabled the fraud to become further camouflaged.

The Court is mindful of the argument that Manhattan's portfolio of United States Government securities was the ultimate source of funds for financing all the transactions in the three certificates of deposit and that the misappro-

14. The Court's discussion of purchases of certificates of deposit does not refer to the $500,000 First National Bank of Boston certificates of deposit, regarding which the complaint is generally devoid of information. From the facts alleged, it does not appear that any fraudulent act was practiced relative to this certificate, and thus the question of standing is irrelevant.

priation of the proceeds of the sale of Manhattan's portfolio constituted the fraud. What is of controlling importance is that the facts as pleaded do not portray Manhattan as the purchaser of the two Belgian American Trust certificates of deposit. Neither Manhattan's portfolio nor the proceeds thereof was the immediate consideration for the issuance of these two certificates.

Nor was Manhattan a purchaser of the third certificate of deposit,—the Irving Trust Company $5,500,000 certificate of deposit which was paid for by the proceeds of the Marine Midland $5,500,000 loan to Garvin, Bantel. Garvin, Bantel and Irving Trust Company were the only parties to the transaction whereby this certificate was issued, although Manhattan was the payee of the certificate. Garvin, Bantel, as previously noted, received physical delivery of the certificate of deposit as collateral for the $5,500,000 loan which initially furnished the consideration for the issuance of the certificate.

Therefore, the Court need not reach the novel and difficult question of whether certificates of deposit of this nature fall within the statutory definition of the term "security".[14a]

14a. Section 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1964), defines the term "security" for the purpose of that act to include "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Section 3(a) (10) of the 1934 Act, 15 U.S.C. § 78c(a) (10) (1964), sets forth the meaning of the term "security" for the purpose of that act:

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The certificates of deposit in this case were not issued for a security—they were issued for cash and are pieces of paper "evidencing the existence of a time deposit." S.E.C. v. Fifth Avenue Coach Lines, Inc., 289 F.Supp. 3, 31 (S.D. N.Y.1968). Thus, they would not be deemed "securities" as a species of the class of instruments designated in the statute as "certificate of deposit for a security."

The S.E.C., however, has taken the position that the antifraud provisions of the securities acts apply to deposit and share accounts in national banks. *See* 31 Fed.Reg. 16,-581, *reprinted in* CCH Fed.Sec.L.Rep. ¶ 77,421 (1966-67 Transfer Binder).

The Supreme Court, in Tcherepnin v. Knight, 389 U.S. 332, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967), held that withdrawable capital shares in a state-chartered savings and loan association were "investment contracts" and, consequently, constituted "securities" under the 1934 Act. The Court noted that the term "security" " 'embodies a flexible rather than a static principle * * *.' " 389 U.S. at 338, 88 S.Ct. at 554.

Giving the definition of "security" this liberal reading, a certificate of deposit issued for cash by a bank could be

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"The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

considered the equivalent of an "evidence of indebtedness" and would be a "security" within the meaning of the 1933 Act.

The 1934 Act, however, does not include the term "evidence of indebtedness" in the statutory definition. Conceivably, a certificate of deposit issued for cash by a bank might be deemed an "investment contract" or more likely a "note". But the specific exclusion of "any note, draft, bill of exchange, or banker's acceptance" having a maturity of nine months or less from the definition under the 1934 Act, would appear applicable to a six-months' certificate of deposit issued for cash by a bank and which evidences a time deposit made at the issuing bank.

DOES THE COMPLAINT ALLEGE FACTS CONSTITUTING A VIOLATION OF THE SECURITIES ACTS?

The Court has expressed its conclusion that plaintiff lacks standing to maintain an action for fraud in connection with the purchase or sale of the Manhattan shares and the three certificates of deposit. Were the Court to follow the consequences of this legal conclusion as to standing, it would be unnecessary for the Court to decide the question of whether the acts charged in the complaint with respect to these particular transactions constitute violations of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act.

However, as the Court has also concluded, plaintiff does have standing to maintain an action alleging fraud in connection with the sale of Manhattan's portfolio of United States Government securities. Consequently, the Court must consider whether the acts charged in the complaint

constitute violations of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act with respect to that particular security transaction.

Plaintiff contends that there was but one pervasive fraudulent scheme, and that all of the various security transactions and other financial manoeuvres were interrelated and cumulative. Since the Court must, for present purposes, accept the allegations of the complaint as true, the Court will determine whether the complaint, considered as a whole, charges conduct which violates section 17(a) of the 1933 Act or section 10(b) of the 1934 Act. Therefore, the Court's discussion will be directed to the complaint as a whole and be general in terms. The Court holds that the allegations of fraud in connection with the sale of Manhattan's portfolio of United States Government securities do not charge conduct violative of the securities acts. The rationale underlying that holding applies equally to the allegations of fraud in connection with the purchase and sale of the Manhattan shares, that is, such allegations do not charge conduct violative of the securities acts. Similarly, if it be assumed that the three certificates of deposit herein constitute "securities" within the meaning of the securities acts, such rationale demonstrates that the allegations of fraud in connection with the purchase of said certificates of deposit do not charge conduct violative of the securities acts.

The gravamen of the complaint is the diminution in Manhattan's assets. This diversion or misappropriation of assets apparently was the essence of the fraud. The allegations describing subsequent conduct charge only that they were designed to conceal the defendants' misdeeds in a maze of numerous intricate and confusing transactions.

A viable claim under Rule 10b-5[15] requires that there have been fraud or deception in connection with the purchase or sale of securities. In interpreting the phrase "in connection with the purchase or sale of any security," it would be relevant to discuss the purpose of the Congressional enactments, and, in so doing, to consider whether the alleged fraud could result in the abuses sought to be curbed or prevented and whether the fraudulent activity otherwise touched on any federal concern.

The securities acts, and especially the 1934 Act, were intended to prevent fraud and deception, manipulation and inadequate disclosure in the dissemination and trading of securities. The securities acts are not so much concerned with fraud *per se* as with the effect of fraud upon investors and the public interest in maintaining free and open securities markets. 1934 Act § 2(3), 15 U.S.C. § 78b(3); Schoenbaum v. Firstbrook, 405 F.2d 200, 212 (2d Cir.), rev'd en banc, 405 F.2d 215 (2d Cir. 1968); S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 858-860 (2d Cir., en banc, 1968); *cf.* A. T. Brod & Co. v. Perlow, *supra.*

In order to sustain a complaint alleging fraud under section 10(b) of the 1934 Act, it must appear with reasonable clarity from the face of the complaint either (1) that a purchase or sale of securities is at the crux of a fraudulent scheme; or (2) that inducing a purchase or sale of securities is the object of a fraudulent scheme; or (3) that fraudulent statements, misstatements, or omissions are made in a manner which is reasonably calculated to influence the investing public, or are of the sort which the reasonable investing

15. On the premise that the more liberal language of Rule 10b-5 is an indication that its scope is more expansive than that of section 17(a) of the 1933 Act, the Court will discuss this issue only in terms of Rule 10b-5. If no claim is established under Rule 10b-5, *a fortiori*, none would exist under section 17(a) of the 1933 Act.

public might rely upon; or (4) that the trading process is abused through potential market manipulation or the spread of watered stock.

The purity of the security transaction and the purity of the trading process are the sole objectives of federal concern. Therefore, the consummation of a security transaction as a mere incident of a fraudulent scheme and the mere fact of injury caused by the fraud, in the absence of any possibility that the fraud might materially affect the purity of the security transaction and the purity of the trading process would not make the fraud federally cognizable. *Cf.* O'Neill v. Maytag, 230 F.Supp. 235, 239 (S.D. N.Y.), aff'd, 339 F.2d 764 (2d Cir. 1964).

Giving the unique factual allegations of the complaint a most liberal reading, the Court concludes that plaintiff was not the victim of "federal fraud," as defined above.[16] A

16. The Court also declines to sustain the sufficiency of the complaint because the injury in this particular case (and thus the benefit of any recovery) was not incurred by anyone who was the subject of federal concern. In view of the unusual fact that the fraud was practiced not upon any member of the "decision-making body" of the corporation (*i. e.*, officers, directors, or shareholders), *see* Globus, Inc. v. Jaroff, 266 F.Supp. 524, 529 (S.D.N.Y.1967); Simon v. New Haven Board & Carton Co., 250 F.Supp. 297, 299 (D.Conn.1966), but only upon creditors and policy holders, it is dubious whether plaintiff corporation was ever defrauded or deceived.

Doubtless, a corporation may be deceived or defrauded even if every member of the board of directors was fully informed of the true facts (or, in factual situations similar to this case, that all of the directors were participants in the scheme). Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. en banc, 1968); Continental Bank & Trust Co. v. Garfinkle, 292 F.Supp. 709 (S.D.N.Y.1968). But, as is evident from Judge Hays' dissenting opinion in the three-judge panel decision in Schoenbaum v. Firstbrook, *supra* (Judge Hays, significantly, having also authored the *en banc* majority opinion reversing the three-judge panel's decision), in such a case, there must be a showing that the directors deceived the shareholders—"the real owners of the property with which the dierctors were dealing." 405 F.2d at 215.

The highly individualized circumstances present in the case at bar—the lack of injury to shareholders—intensifies the Court's reluctance to hold that the complaint states a claim of federal fraud.

federal claim is not pleaded by allegations that, in the course of a scheme to loot a corporation of its assets, certain security transactions occurred, when these transactions—though contaminated by the overriding evil intent to accomplish the ultimate looting—did not involve fraud or deceit in connection with the sale or purchase of a security.

Manifestly, the sale of Manhattan's portfolio and the purchase of the Manhattan shares were necessary steps toward the ultimate looting of Manhattan's assets. But Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.[16a]

The complaint, taken as a whole, alleges no more than a common law action for misappropriation of corporate funds by a fiduciary, embezzlement or fraudulent conveyance perhaps, or the distribution of an illegal dividend. None of

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16a. The distinction here drawn can be best illustrated by analogy to the general conspiracy statute, 18 U.S.C. § 371 (1964), which makes unlawful a conspiracy when one or more of the members of the conspiracy "do any act to effect the object of the conspiracy." In order for conduct to qualify as an overt act under that statute, the conduct need not, of itself, be unlawful, provided it was done to effect the object of the conspiracy. Nevertheless, unless the act done in furtherance of the conspiracy was itself unlawful, although committed for the purpose of furthering the object of the conspiracy, the overt act may not serve as the basis for a criminal prosecution for a substantive crime.

Similarly, in this case, the various security transactions were overt acts committed for the purpose of promoting and effecting the object of the fraudulent conspiracy (*e. g.*, the sale of Manhattan's portfolio of United States Government securities was necessary to effectuate the looting of Manhattan's assets). However, unless such security transactions were independently unlawful—*i. e.*, unless there was fraud in connection with the purchase or sale of a security—they could not serve as the basis for a substantive claim under section 10(b) and Rule 10b-5. As pleaded, the security transactions themselves, when considered from the viewpoint of section 10(b) and Rule 10b-5, were innocuous though constituting overt acts furthering the fraudulent scheme. Consequently, they cannot serve as the independent predicate for liability under section 10(b) and Rule 10b-5.

these actions, in the absence of diversity of citizenship, can be maintained in a federal court.

Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964) and Shoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir., en banc, 1968) do not hold otherwise. In *Ruckle,* the corporation proposed to issue its own shares to the president for a less than adequate consideration. A majority of the board withheld material information from one of the directors before approval was voted. The court held that the issuance would constitute a violation of Rule 10b-5.

In *Schoenbaum,* the court held that the issuance of stock by a corporation to its controlling stockholder at "vastly inadequate prices," apparently with each board member having full knowledge of the inadequacies (all were named as co-conspirators and defendants), stated a claim for relief under section 10(b) and Rule 10b-5.

The crucial facts in these cases were that, in each, the "fraudulent practice" was deception (whether of directors or shareholders) which directly resulted in the issuance of stock for inadequate consideration, thus creating the danger of the spread of "thin" or "watered" stock. The direct involvement of the deceit with a transaction of securities is fraud "in connection with" the sale of stock, and, consequently constitutes federal fraud irrespective of whether it also constitutes corporate mismanagement. As the three-judge panel in Schoenbaum v. Firstbrook, *supra,* stated: "A fraud upon a corporation which has the effect of depriving it of fair compensation for the issuance of its stock would necessarily have the effect of reducing the equity of the corporation's shareholders and this reduction in equity would be reflected in lower prices bid for the shares on the domestic stock market." 405 F.2d at 208.

The facts in the instant case, on the contrary, could not give rise to any of these dangers and do not evidence that the fraud was rooted in a security transaction.

That the complaint in this case states no more than a non-federal common law cause of action becomes even more evident upon consideration of the factual situation and language of the Court of Appeals in Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967). Plaintiffs there alleged, inter alia, that defendant Genesco, a 94% stockholder in S. H. Kress & Co. had acquired its shares pursuant to a fraudulent conspiracy, the purpose of which was to finance its purchases of Kress stock from Kress' own assets and to manage Kress for Genesco's own benefit, appropriating Kress' assets in the meanwhile. After holding that plaintiffs could not maintain an action charging violations of Rule 10b-5 occurring before plaintiffs had acquired their shares, the court stated (as to the period subsequent to plaintiffs' acquisition of shareholder status) that the "fraudulent activities then alleged are primarily corporate abuse and diversion, claims cognizable under state law but not under the Act." 384 F.2d at 546. Only the claim that defendants had "manipulated the market price of Kress stock, keeping Kress dividends to a minimum, in order to force minority stockholders to sell out to Genesco at depressed values," *id.*, stated a good cause of action under Rule 10b-5.

The complaint in this case also fails to allege any actual or potential abuse of the trading process. Since public distribution of watered or valueless stock was not a part of the scheme, and the fraud had no potential manipulative effect on the market, and did not raise the spectre of any other evil which prompted passage of the securities acts

or is a subject of federal concern, the factual situation in the instant case differs significantly from those in the cases plaintiff cites as major support for sustaining the validity of its claim.

A. T. Brod & Co. v. Perlow, *supra,* explicitly found that the fraud was federally cognizable because it had a "potentially manipulative effect on the securities market." 375 F.2d at 397.

Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814, 81 S.Ct. 695, 5 L.Ed.2d 693 (1961), is also stressed heavily by plaintiff. In that case, an individual named Cage was required to sever his connection with the plaintiff corporation (the nominal plaintiff was the corporation's trustee in bankruptcy) when a new group acquired control. Cage concocted a scheme whereby he induced the plaintiff's transfer agent to issue new shares with a market value of about $700,000 after transferring to the corporation worthless contract rights. The actual fraud appeared to be the false representations made to the transfer agent by certain former officers of the corporation and the phony corporate documents prepared to justify and legitimize the issuance of stock. The scheme also involved the distribution by Cage and his cohorts of this newly issued stock over security markets to unwary members of the investing public. Because the purpose and object of the scheme were to have valuable corporate stock issued to Cage (actually to another corporation controlled by Cage which was liquidated immediately after receiving the stock) in exchange for worthless consideration, and then to distribute the stock publicly, the fraud was definitely "in connection with" the purchase and sale of securities. The scheme induced an unfair sale

of securities and it had as a major purpose the spread of watered stock to many investors.

In Pettit v. The American Stock Exchange, 217 F.Supp. 21 (S.D.N.Y.1963), a similar scheme was perpetrated when huge amounts of Swan-Finch stock was issued, through various corporate shells, for worthless consideration, and then distributed over the American Stock Exchange. That court noted that the fraud violated Rule 10b-5 because the transaction represented an "abuse of the securities trading process," and because the "heart of this case are two fraudulent transactions in securities." 217 F.Supp. at 25-26.

Each security transaction herein was effected for full and fair consideration with full knowledge in both purchaser and seller as to the value of the securities sold. Where this has occurred Rule 10b-5 is not violated. *See* Fleischer, "Federal Corporation Law": An Assessment, 78 Harv.L.Rev. 1146, 1166 (1965). Only where the security transaction was a "vital aspect of a continuing scheme," should the fact of subsequent misappropriation of the consideration result in a violation of Rule 10b-5. *Compare* Cooper v. North Jersey Trust Co., 226 F.Supp. 972, 978 (S.D.N.Y.1964), *with* S.E.C. v. Fifth Avenue Coach Lines, Inc., 289 F.Supp. 3, 36-39 (S.D.N.Y.1968).

The complaint in this case presents no more than a complicated scheme of common law fraud.[17]

Discovery herein has been extensive. The parties have not called to the Court's attention any facts which were not alleged in the complaint and which would, if leave to amend

17. Plaintiff instituted such a common law action in New York County Supreme Court in 1965. After joinder of issue, further proceedings in the action were enjoined. The factual allegations of the complaint filed in the state court proceeding are essentially the same as those contained in the complaint herein.

the complaint were granted, state a cause of action under the securities acts. Accordingly, the Court hereby dismisses the complaint as to the movants and hereby directs that judgment be entered for movants. Fed.R.Civ.P. 54(b).

So ordered.